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FEDERAL TRADE COMMISSION  
WASHINGTON, D. C. 20580

BUREAU OF ECONOMICS

November 1, 1985

Richard J. Keane, Chairman  
Assembly Agriculture Committee  
New York State Assembly  
State Capitol Building  
Albany, New York 12248

Dear Chairman Keane:

The staff of the Federal Trade Commission is pleased to respond to your Notice of Public Hearing concerning New York's milk dealer licensing regulations.<sup>1</sup> The Federal Trade Commission (the "Commission") is charged by the United States Congress with preserving competition and protecting consumers from deceptive and unfair business practices.<sup>2</sup> Accordingly, the Commission and its staff provide comments to federal, state, and local legislative and administrative bodies to suggest procompetitive approaches to various policy issues. Our objective is to assist decision-makers in analyzing legislative or regulatory proposals that may affect competition and consumer welfare.<sup>3</sup>

While we recognize that New York has a legitimate interest in protecting the health and safety of its milk consumers, we are concerned that the state's territorial licensing of milk dealers may be an unnecessarily restrictive means of achieving this goal. Furthermore, we believe that territorial licensing may harm

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<sup>1</sup> These comments represent the views of the Bureaus of Competition, Economics, and Consumer Protection of the Federal Trade Commission and do not necessarily represent the views of the Commission or any individual Commissioner. The Commission, however, has authorized the submission of these comments.

<sup>2</sup> See 15 U.S.C. 41 et seq.

<sup>3</sup> The Commission's letter of February 27, 1984, to Commissioner Gerace described the Commission's view of the proper analysis for determining whether to grant entry into the milk market. That letter was submitted in connection with an application by Tuscan Dairy Farms, Inc., for a license to sell milk in certain New York counties. We incorporate by reference the general analysis and recommendations set forth in that letter (attached) in this submission. February 27, 1984 letter from the Federal Trade Commission to Commissioner Joseph R. Gerace, New York State Department of Agriculture and Markets.

consumers by inhibiting sellers' abilities to respond to changes in consumer demand, market demographics, and technological developments.

Our comments first briefly describe our understanding of New York's milk dealer licensing system. In section two, we examine the potential competitive effects of current licensing regulations on milk consumers, retailers, dealers, and dairy farmers. We also discuss the administrative costs of the current regulations. In the third section, we discuss the concept of "destructive competition." In section four, we examine the proposal to expand licensing territories. Finally, we examine changes in New York's laws that we believe would enhance competition in the milk industry and benefit New York's citizens.

### I. New York Milk Dealer Licensing Regulations

While other states have regulated dairy products in various ways, including direct price controls, to our knowledge, New York is the only state that maintains a licensing program that limits milk dealer operations to specific geographic areas.<sup>4</sup> As we understand it, licenses are presently issued to milk dealers entitling them to sell or distribute milk within a specific county, or in a specific region within a county.<sup>5</sup> The applicable licensing statute provides that:

No license shall be denied to a person not now engaged in business as a milk dealer, or for the continuation of a now existing business, and no license shall be denied to authorize the extension of an existing business by the operation of an additional plant or other new additional facility, unless the commissioner finds by a preponderance of the evidence, after due notice and opportunity of hearing to the applicant or licensee, one or more of the following: (1) that the applicant is not qualified by character or experience or financial responsibility or equipment properly to conduct the proposed business, provided, however, that no new application shall be denied solely for

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<sup>4</sup> May 15, 1985, memorandum from Richard M. Kessel, New York State Consumer Protection Board, to Governor Mario M. Cuomo.

<sup>5</sup> Department of Agriculture and Markets, Milk Dealer Licensing Policy and Procedure, p. 2. A market is "any county, city, town or village or two or more cities and/or towns and/or villages and any surrounding territory designated as a natural marketing area." Agriculture and Markets Law section 253(5) (McKinney 1984-85). The Agriculture Commissioner has defined each county as a natural marketing area. 1 N.Y.C.R.R. 27.1

the reason of inadequate equipment if it is shown that provision has been made for the acquisition of same; (2) that the issuance of the license will tend to a destructive competition in a market already adequately served; or (3) that the issuance of the license is not in the public interest.<sup>6</sup>

Administration of the licensing laws permits already licensed firms to delay or prevent entry by new competitors by opposing an entrant's application. A prospective entrant can be denied a license if its presence would result in "destructive competition" in an area already "adequately served." As noted by the Legislative Commission on Expenditure Review, "competing milk dealers almost always oppose granting [a] license."<sup>7</sup> If existing milk dealers can delay or preclude entry by competitors, the existing firms may in some circumstances be able to enjoy higher prices than would prevail under more open competition. As the Attorney General of the State of New York told the Agriculture Committee in 1982, by requiring a prospective entrant to demonstrate that his entry will not cause destructive competition, the State is preventing "plain old competition."<sup>8</sup>

## II. Current Licensing Regulations: Effects and Costs

### A. Effect on Consumers

The current regulations which impose territorial licensing restrictions on milk dealers appear to limit competition among dealers and have the potential to increase the costs of milk processing and distribution. As a result, the retail price of milk may be elevated.<sup>9</sup> At the same time, we are unaware of any

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<sup>6</sup> Agriculture and Markets Law section 258-c (McKinney 1984-85).

<sup>7</sup> Legislative Commission on Expenditure and Review, April 1985 Audit, State Milk Dealer Licensure and Regulation.

<sup>8</sup> Testimony of Robert Abrams, Attorney General of the State of New York, at a Hearing of the Standing Committee on Agriculture on the Issue of Milk Dealer Licensing Deregulation, February 3, 1982, p. 3.

<sup>9</sup> Several surveys have confirmed that New York residents pay more for milk than consumers in surrounding areas. The New York Consumer Protection Board found that the New York State average price of milk is at least 20 cents per gallon more than in neighboring states. See Memorandum from Richard M. Kessel, New York State Consumer Protection Board, to Governor Mario M. Cuomo, supra note 4. It is not clear that territorial licensing alone accounts for all of the price difference.

evidence suggesting that these regulations increase the health and safety of New York consumers. As far as we know, other states that do not use New York's unique regulatory approach are able to maintain the quality of their milk supply and the health of their consumers.

#### B. Effect on Milk Retailers

New York's current licensing system has at least two economic effects on milk retailers.<sup>10</sup> First, because license applications are neither approved with certainty nor processed expeditiously, the number of suppliers a retailer can deal with may be artificially limited.<sup>11</sup> The ability of retailers to "shop" among suppliers is crucial so that consumers can be offered milk at the lowest possible price. To compete more successfully, supermarkets have a strong incentive to reduce their purchase cost of such important items as milk products. However, territorial licensing restrictions may reduce the prospect of competitive entry, which reduces competitive pressure and may tend to generate higher wholesale and retail prices.

Second, territorial licensing restrictions may restrict the ability of retailers to vertically integrate into fluid milk processing.<sup>12</sup> Integration, or just the threat of it, pressures dairies to price more competitively and operate more efficiently to

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<sup>10</sup> Section 257 of the Agriculture and Markets Law exempts a retailer from licensing, unless the retailer processes or resells milk. Agriculture and Markets Law section 257 (McKinney 1984-85). However, all milk purchased by a retailer must be provided by a licensed dealer.

<sup>11</sup> A study based on 1982 and 1983 license applications indicates that decisions on applications for new licenses take an average of 84 days to be granted. Approvals of requests to extend the territory served require an average of 278 days. During the same period, three requests for new licenses and five requests for market extensions were rejected. These statistics may understate the extent to which entry is inhibited if some milk dealers did not apply for a license or an extension because they believed that they would be rejected. See Legislative Committee on Expenditure Review, op. cit., p. 19, 21.

<sup>12</sup> New York officials noted that New York's regulations may have prevented some efficient vertical integration. See Testimony of Robert Abrams, supra note 8, p. 4. Vertical integration of supermarkets into fluid milk processing appears to have been one of the most significant structural changes in the milk industry during the 1960s. See A. Manchester, "Market Structure, Institutions, and Performance in the Fluid Milk Industry," Agricultural Economic Report No. 248, U.S. Department of Agriculture (1974), p. 1.

maintain their position in the fluid milk market. Because licensing is required in New York before integration can be achieved, competitive pressure is attenuated as supermarkets confront this barrier to entry.

### C. Effect on Milk Dealers

New York's territorial licensing restrictions may reduce competition among milk dealers.<sup>13</sup> In unregulated markets, the fear that a new firm or firms will enter and undercut existing prices is often a strong check on non-competitive behavior. New entrants are frequently the source of innovative services. However, a milk dealer wishing to sell milk in a new territory in New York must first obtain a license. Even if the prospective competitor ultimately succeeds in obtaining the license, his entry is generally delayed, and he incurs costs in obtaining the license. Unless a milk dealer expects to earn sufficient profits to cover the cost of obtaining the license, he will not enter the market. Therefore, the necessity of incurring these costs may in itself make unprofitable some competitive entry that would have been profitable in an unregulated market.

### D. Effect on Dairy Farmers

New York's territorial licensing restrictions may also have detrimental effects on dairy farmers. Given the price of raw milk, dairy farmers have an interest in selling as much raw milk as possible. Dairy farmers should prefer that milk is processed and delivered to retailers in the most efficient method. This will tend to result in the lowest retail price of milk, thus generating the greatest sales of fluid milk. The licensing process frustrates this goal. By restricting competition at wholesale and retail levels, territorial licensing may increase wholesale and retail prices but not the price received by the dairy farmer. In addition, territorial licensing of processors and retailers may discourage processors from investing in larger-scale, more efficient plants. Due to the difficulty in obtaining licenses to supply larger areas, retailers may be precluded from integrating vertically; and the limited number of licensees may foster less competitive pricing or even direct price-fixing. As a result, retail prices may be higher than would occur in a free market. If this occurs, dairy farmers will sell less raw milk and will have to seek other less profitable outlets for their raw milk.

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<sup>13</sup> The Attorney General of the State of New York testified that "the milk dealer licensing laws...not only restrict competition but virtually invite combinations in restraints of trade." Testimony of Robert Abrams, supra note 8, p. 9.

#### D. Administrative Costs

New York's licensing system apparently involves significant administrative costs. Present licensing procedures, as documented by the Legislative Commission on Expenditure Review,<sup>14</sup> are cumbersome, expensive, and time consuming for established and prospective dealers and reviewing officials. During 1983-84, total expenditures for milk licensing and regulation were \$1.7 million. Even though much of this comes from levies on milk sales and from license fees, consumers in New York ultimately pay these administrative costs in the retail price of milk.<sup>15</sup> In addition, an administrative cost is incurred by licensees and applicants to provide the required reports and participate in hearings related to applications or renewals. Again, these private costs of milk licensing are passed on to consumers. Prospective entrants must balance the cost of filing an application and the likelihood of receiving a license against any possible profits to be gained by entering a market. These administrative costs and the uncertainty of receiving a license might deter otherwise desirable entry. All of these costs are ultimately borne primarily by New York consumers in the form of higher milk prices and state taxes. The licensing process could be simplified and made less costly by eliminating territorial licensing restrictions.

#### III. Destructive Competition

One of the key concepts in the New York State milk regulation scheme is that of "destructive competition." The law provides that an application for a license can be denied if "the issuance of the license will tend to a destructive competition in a market already adequately served."<sup>16</sup> It appears that incumbent dealers frequently argue that granting additional licenses would result in destructive competition.

The Federal Trade Commission actively monitors the dairy industry throughout the United States. In recent years, no evidence has come to our attention indicating that "destructive

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<sup>14</sup> April 1985 Audit, State Milk Dealer Licensure and Regulation, supra note 13.

<sup>15</sup> Ibid., Table 6, p. 35 and related discussion, pp. 34-36. The total expenditures includes amounts for maintenance of milk market orders and security funds designed to protect producers. Deducting these expenditures still leaves more than \$1 million spent on licensing and other regulatory activities.

<sup>16</sup> Agriculture and Markets Law section 258-c (McKinney 1984-85).

competition" is a problem in the dairy industry in states that do not require territorial licenses such as those required in New York. To our knowledge, the performance of the dairy industry in other states has been quite satisfactory, even in the absence of territorial licensing restrictions.

It appears to us that the concern of "destructive competition" reflects the fear of incumbent firms that they might be forced to exit from the market or may earn lower profits if new competitors are permitted to enter. However, if milk dealers are driven from the market by new competition, it is because their costs are higher than those of their competitors; otherwise, they would be able to survive in the more competitive environment. If high-cost sellers exit from the market, consumers are not harmed. Rather, consumers are made better off by the presence of low-cost firms and the opportunity to purchase milk at a lower price.

It also seems unnecessary to evaluate whether an area is already "adequately served" when a new firm seeks to enter. That the firm wishes to enter, and is willing to incur the necessary cost, is an indication that it thinks it can earn a profit in that market, either by providing services more efficiently than existing firms or by undercutting existing supracompetitive prices. Either the absence of efficient firms or the presence of supracompetitive prices is ample evidence that an area is not being "adequately served." Thus, it seems to us that anytime a firm wishes to enter a market, the firm should be permitted to do so without the kind of licensing restrictions currently imposed in New York.

#### IV. Proposed Expansion of Territories

One proposed change in the existing milk licensing laws would expand the territories defined as "natural marketing areas" to multicounty territories.<sup>17</sup> While this proposal would improve the existing system, it would still restrict free entry and inhibit market forces unnecessarily. A multicounty market designation would still result in arbitrary licensing regions and would involve economic and administrative costs similar to those in the current system.

This proposal has apparently been recommended as a means of gradually opening up markets. We see no reason to take such an intermediate step and recommend consideration of the complete elimination of the territorial licensing system. Market forces should be allowed to define "natural marketing areas." However,

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<sup>17</sup> June 5, 1985 Recommendation of the New York Department of Agriculture and Markets.

if the expansion proposal is the only available alternative to the current system, we recommend adopting it over the current system.

#### V. Recommendations

In recent years, many states have ended unnecessary economic regulation of the milk industry. The best example of this is the decision of many states to terminate the direct regulation of wholesale and/or retail milk prices. In 1970, 14 states directly regulated wholesale or retail fluid milk prices.<sup>18</sup> By 1984, only six states continued to set prices.<sup>19</sup> Thus, eight states apparently concluded that market conditions in the fluid milk industry did not require continued economic regulation. We are aware of no evidence suggesting that these states have suffered any reduction in the safety of their milk supply or the health of their residents as a result of these changes. New York would be following these precedents if its milk licensing program were modified to eliminate unnecessary economic regulation.

The staff of the Federal Trade Commission recommends that serious consideration be given to removing the current economic restrictions on the entry of milk dealers. The current regulations may limit competition among milk dealers and introduce unnecessary administrative impediments to the flexible operation of milk markets. They impose obvious administrative costs on both the state and the firms and may result in excessive retail prices. Further, there is no evidence, of which we are aware, that these regulations are needed to protect the health, safety, and welfare of New York citizens. Thus, it appears that New York consumers are likely to benefit from the elimination of the existing geographic licensing restrictions.

Sincerely yours,

*David T. Scheffman*  
David T. Scheffman  
Acting Director

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<sup>18</sup> The states that directly regulated prices in 1970 were Alabama, California, Louisiana, Maine, Mississippi, Montana, Nevada, North Dakota, Pennsylvania, South Carolina, South Dakota, Vermont, Virginia, and Wyoming. See Manchester, supra note 12, Table A-2.

<sup>19</sup> These states are Maine, Montana, Nevada, North Dakota, Pennsylvania, and Virginia. See Krueger, "An Update of State Milk Control Programs," Dairy Outlook and Situation, Economic Research Service, USDA, 1981. South Carolina discontinued price regulation subsequent to 1981.