

# SECTOR INQUIRY INTO RAW MILK AND DAIRY MARKET

## EXECUTIVE SUMMARY

(1) The Competition Council of the Republic of Lithuania (the CC) launched a sector inquiry into the raw milk and dairy products' market (the Sector Inquiry) on 23 December, 2014. The Sector Inquiry was issued due to the importance of the sector under consideration, uneven changes in raw milk and dairy products' prices and the fact that this sector has previously been investigated by the CC on several instances.

(2) The Sector Inquiry was not targeted at individual companies or associations. Instead, it classified the competition problems beyond potential individual violations of competition law. Its general aim was to give market participants and political decision-makers an in-depth insight into the competition situation in the milk sector and the relevant framework for its assessment under competition law. The final report therefore does not make any conclusive assessment of or statements about the competition situation in individual cases.

(3) The preliminary results of the Sector Inquiry were published for public review on 22 July, 2015. The CC has received 4 reviews from Lithuanian Institute of Agrarian Economics, the Ministry of Agriculture of the Republic of Lithuania (the Ministry of Agriculture), Seimas of the Republic of Lithuania (the Parliament) and the Association of Agricultural Companies. The reviews have been taken under consideration while drafting the final report on the Sector Inquiry.

(4) In the course of the Sector Inquiry the CC has sent out requests for information to 91 market players in total: 10 largest milk producing companies, all 42 cooperatives currently operating in the market, 20 other milk buyers<sup>1</sup> (other buyers), 13 dairies<sup>2</sup> and 6 supermarket chains. The response rates were as follows: 40% for the largest milk producing companies, 79% for the cooperatives, 75% for other buyers, 77% for dairies and 100% for supermarket chains. The CC therefore considers to have collected information from a significant part of the raw milk purchasing and dairy retail markets.

(5) The CC has also collected information and statistical data from other public institutions supervising the sector and has held numerous meetings with market players and market organisations such as Chamber of Agriculture and Lithuanian Institute of Agrarian Economics to discuss problems and prospects of the sector.

(6) The CC has found that there might be an imbalance in the bargaining power between market players, given a specific nature of raw milk as a product. Raw milk cannot be stored and therefore has to be sold on the same day as it was produced, which puts milk producers into a weaker bargaining position, compared with dairies. However, there are mechanisms in the market that could help redistribute bargaining power between market players and create a significant counterbalance. This could promote market players' effectiveness and in turn provide more benefits to the final consumers. After analysing all four levels of the milk sector – production, buying up, processing and distribution – the CC has drawn the following conclusions.

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<sup>1</sup> Various firms (not cooperatives) purchasing raw milk for reselling purposes.

<sup>2</sup> It should be noted that 5 major milk dairies process approximately 94% of all raw milk processed in Lithuania.

(7) The CC has found that the buying up price for the raw milk mainly depends on the bargaining power of the milk seller (milk producer, cooperative or other buyer), which in turn depends on the quantity of raw milk being sold. Thus the most effective way to increase bargaining power is to increase the quantity of raw milk in the raw milk sellers' disposal.

(8) Despite this conclusion, 74% of all Lithuanian milk farms are small farms with a herd size of only 1-5 cows. In comparison, in Latvia such small farms comprise to 56% of all Latvian farms<sup>3</sup>, whereas an average herd size in the EU is 29 cows<sup>4</sup>.

(9) However, there are ways and mechanisms in place for small farms to cooperate (to create new or join the existing cooperatives), collectively increase the quantity of raw milk at their disposal and therefore improve their bargaining power.

(10) It is the most beneficial for farmers supplying raw milk to cooperatives when they are members of those cooperatives<sup>5</sup>. Member of a cooperative has the right to claim part of cooperative's profit (dividends), which is proportionate to member's share contribution made at the time of joining the cooperative and to the achieved turnover (quantity of milk supplied to the cooperative) via cooperative. A member of a cooperative has also the right to participate in cooperative's management and decision making process. In other words, members of the cooperative can not only receive a higher price for the raw milk they supply, compared to individual selling, but also gain additional benefits through membership.

(11) However, the CC has established that significant state support aimed at creation of new cooperatives might have distorted the market and fostered the creation of "false" cooperatives – cooperatives that operate similarly to intermediaries rather than cooperatives that bring benefits to their members. It has been found that almost one third of currently operating cooperatives in Lithuania have 5 or less members (some of which may not even be milk producers themselves), and the share of raw milk purchased from those members is extremely low – from 0% to 15%. This essentially means that sole suppliers, supplying raw milk to such cooperatives, do not have any rights to participate in their management or profit division.

(12) Since a member of a cooperative is normally interested in cooperative's profitability, it is not economically rational to supply his raw milk to someone else (not a cooperative), unless other buyer's offered price significantly exceeds the price paid by the cooperative in such way as to cover the loss of dividends and benefits of being able to participate in cooperative's management. It is therefore unlikely that a member of a cooperative could receive a price offer from someone else that is significantly higher than cooperative's offered prices, taking into account the benefits of being a member of a cooperative.

(13) Milk production and processing are subject to the prohibition of cartels like any other market. However, with the provisions of the Milk Package, the legislator has created extensive exemption areas from the general prohibition of cartels for this sector. The Milk Package allows milk producers to establish producer organisations (POs), increasing raw milk quantity and in turn making raw milk suppliers' (including cooperatives') bargaining power stronger. The Milk

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<sup>3</sup> <http://www.slideserve.com/afric/milk-sector-in-latvia-future-d-evelopments>

<sup>4</sup> [http://ec.europa.eu/agriculture/ricaprod/pdf/Dairy\\_Farms\\_report\\_2013\\_WEB.pdf](http://ec.europa.eu/agriculture/ricaprod/pdf/Dairy_Farms_report_2013_WEB.pdf)

<sup>5</sup> Majority of Lithuanian cooperatives purchase milk not only from their members, but also from non-members (sole suppliers). Some cooperatives may only the minimum number of members required at the time of establishing the cooperative (5 members) and hundreds of sole suppliers. In such cases the benefits in terms of cooperative's management and profit division process can only be enjoyed by a small number of people.

Package has therefore already taken account of the imbalance of power in the relationship between dairies and milk producers and between dairies and the retail trade.

(14) However there is still no POs established in Lithuania. In the CC's opinion, this might be due to the lack of information in the market – market players do not have enough information regarding what exactly is a PO, who can be its members, what is the aim and purpose of such organisations and how to establish them. According to the Ministry of Agriculture, it is constantly reminding various market organisations about the possibilities to establish POs, but there is a lack of initiative from those organisations and market players themselves.

(15) According to the data collected by the CC, there were 9 cooperatives, 2 dairies and 1 other buyer that exported raw milk during 2012-2015. The most common reason indicated by the market players for not exporting raw milk was its low quantity. However it is important to note, that export is not necessary in order to profitably undertake the business of raw milk supply. This conclusion has been confirmed by some of the market players' information provided to the CC – even 31% of cooperatives that do not export raw milk and 15% of other buyers that do not export raw milk stated, that they do not feel the need to export raw milk abroad and that they are content with the domestic market. In addition, it has been found that the weighted profit margins of domestically operating cooperatives almost doubled the weighted profit margins of exporting cooperatives.

(16) In the course of the Sector Inquiry the CC could not confirm some of the market players' fears that dairies tend to choose more expensive imported raw milk in order to keep the prices low in the domestic market. It has been found that imported raw milk was cheaper than domestic raw milk in 62% of the instances in 2014. Besides, the data shows that there has been a shortage of raw milk during the investigated period – imported raw milk quantities highly exceeded exported ones, therefore the periods of more expensive imports might be associated with that. It is also important to note that after the embargo announced by the Russian Federation in August 2014, Lithuanian dairies are decreasing the quantities of imported raw milk and purchase larger proportion of raw milk domestically.

(17) There have been fears expressed by the market players publicly and during the meetings with the CC, that cooperatives are being discriminated by dairies, mainly by paying cooperatives lower prices compared to single farmers, even though cooperatives supply much higher quantities of raw milk<sup>6</sup>. The CC has found that price differences might be explained by objective factors, influencing raw milk price, such as raw milk quantity, quality, as well as loyalty and stability of supply. According to the data collected, 50% of currently operating cooperatives in Lithuania supplied raw milk to up to 6 dairies in 2013. This means that either cooperatives often change their clients or they divide the total raw milk quantity at their disposal and supply to several dairies at the same time. In the former event this shows that cooperatives may not be loyal and stable suppliers in the eyes of dairies, while in the latter – that quantity of raw milk is reduced by dividing it into several parts, which in turn reduces the bargaining power of such cooperatives. In contrast, the data shows that the largest milk producing companies usually supply all their milk to one dairy.

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<sup>6</sup> It has been stated by the cooperatives that dairies pursue such tactics in order to break cooperatives down and make cooperation seem unattractive.

(18) When analysing the tendencies of raw milk prices, the CC considered Lithuanian prices for raw milk and compared them to the changes in global dairy trade (GDT) index. The analysis showed that changes in Lithuanian raw milk prices are in line with the tendencies of GDT index. However, Lithuanian raw milk prices react to changes in GDT index with 1-2 months' lag, which is normal, considering the fact that raw milk prices are usually negotiated in advance, whereas at any point in time it is only possible to know up to 2 weeks old GDT index.

(19) The Sector Inquiry aimed to identify the reasons why raw milk prices have decreased more than the prices of dairy products: according to the data collected by the CC, raw milk prices decreased by approximately 35% during the period of January 2014 – February 2015, whereas the prices of dairy products<sup>7</sup> decreased by approximately 11% during the same period of time. The data shows that after an embargo announced by the Russian Federation, the quantity of dairy products sold by the largest Lithuanian dairies decreased by 20-38%. Following an economic logic, once the demand for dairy products decreased, the unchanged fixed costs of dairies had to be distributed among a smaller quantity of products, which means that the portion of fixed costs in a dairy product increased which to some extent diminished the effect of the reduction in raw milk's price. In addition, it was found that raw milk's share in retail price constituted approximately 49,8% during the period of January 2014 – February 2015, which means that the decrease in raw milk's price cannot be met by an equal decrease in retail price.

(20) In light of the findings of the Sector Inquiry, the CC has drawn the following suggestions and recommendations. The CC suggests that the Ministry of Agriculture, Chamber of Agriculture and other responsible state institutions and organisations provide market players with more information regarding the possibilities and benefits of establishing POs. The CC also suggests establishing certain mechanisms of control so that cooperatives receiving state support are the ones operating on the basis of membership, ensuring that milk producers, supplying milk into such cooperatives, receive maximum benefits from their membership. Having in mind that there are many cooperatives currently operating in Lithuania, the CC suggests considering supporting already operating genuine cooperatives, instead of the creation of new cooperatives, and to also take into account whether members of such cooperatives are themselves milk producers. The CC also recommends setting the proportion of raw milk that cooperatives have to purchase from its members as opposed to sole suppliers.

(21) Having in mind that both cooperatives and dairies have stated their preference for longer term contracts, the CC suggests setting the minimum contract length in the Milk Procurement Rules that set out the recommended form of raw milk selling-purchasing contracts. In such a way the uncertainty associated with raw milk supply and demand could be reduced, at the same time bringing more stability and trust into the relationship between cooperatives and dairies. According to the Ministry of Agriculture, the suggestion to set the minimum contract length of 3 months has been discussed on numerous occasions, however it was not supported neither by milk producers, not by dairies. According to the Ministry of Agriculture, when prices for raw milk are low, dairies are the ones interested in longer term contracts, whereas when the prices are high, this is something of milk producers' interest. This is why the agreement has not been reached so far.

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<sup>7</sup> Both wholesale and retail prices.

(22) According to the preliminary evaluation by the CC, the price change mechanism could solve the contract problem, provide more clarity to changes in raw milk prices and encourage milk producers (or cooperatives) and dairies to enter longer term contracts. A possible mechanism could be a certain formula included in the contract. However it is important that such formula is negotiated and agreed upon on a case basis (in every contract separately), i.e. formula does not have to be universally applied in order not to create price regulation. It is also worth noting that inclusion of such formula in contracts does not mean that the contract cannot be terminated when market conditions change.

(23) On 9 July 2015 the law prohibiting unfair practices among undertakings, supplying and purchasing raw milk (the Law) was introduced. The Law attempts to regulate certain aspects of milk market. However the CC's position is that Lithuanian state institutions should evaluate other solutions suggested at the EU level (e. g. Milk Package) and apply measures that would ensure long term effectiveness and competitiveness of undertakings operating in milk market.

(24) The CC will continue to monitor developments in raw milk and dairy products' sector and will investigate any possible breaches of competition law should this be necessary.

See the text of the Sector Inquiry report (in Lithuanian):

[http://kt.gov.lt/teise/nut/2015-12-30\\_1S-138.pdf](http://kt.gov.lt/teise/nut/2015-12-30_1S-138.pdf)