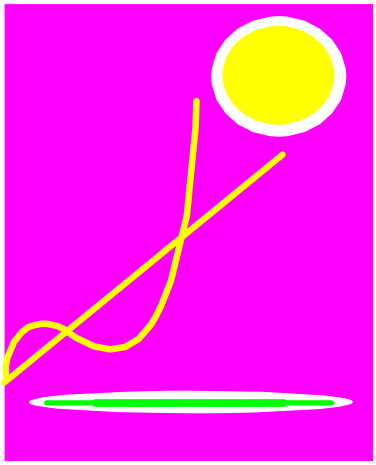

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by

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Answers to Questions that Often Surface When Discussing the Proposed Connecticut Fair Pricing Milk Law

May 1, 2003

by

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Introduction:

This briefing paper is in a question and answer format. If you are interested in exactly how the fair share law fits with other dairy policy initiatives and how it addresses a new dairy pricing problem – excessive market power in the fluid milk marketing channel this paper is for you. The last two questions and answers are the MUST READ section of this paper. The rest , however, is useful prologue that addresses very serious concerns that many have.

Question:

Why not let Northeast farmers go out of business? We can get cheaper milk from the Midwest.

Answer:

Traditionally, milk has been cheaper in the Midwest and raised the question about how much it costs to transport milk or milk products from there to here. If we let Northeast dairy farmers go out of business would we get cheaper milk and milk products from the Midwest? Today the answer is no. Recently Midwest farmers have received more, not less, for milk than Northeast farmers. According to the Hoard's Dairymen reported mailbox prices, the prices that farmers actually received in October 2002 were $11.74 per hundred pounds of milk in the Northeast and $12.38 per hundred in Wisconsin. Ohio prices were also higher at $11.85 per hundred. In January 2002, Wisconsin farmers received $11.60, only two cents less than Northeast farmers $11.62. Ohio farmers received $11.70, eight cents more than Northeast farmers. Think about it. If the milk supply shrinks in the Northeast, consumers will have to switch to products produced with

raw milk that is if anything, higher priced and one also has added transportation costs. Prices would be higher, not lower.

An update on regional farm level prices

The April 25,2003 issue of Hoards Dairyman reports annual average mail box prices for 2002. For the Northeast mailbox prices averaged $11.89 per hundredweight. For the upper Midwest (Minn and Wisconsin) mailbox prices for 2002 averaged $11.87. Two cents per hundred weight is nowhere near sufficient to pay for the transport of milk or milk products from the upper Midwest to New England.

Question:

Traditionally milk prices are significantly lower in the Midwest due to its huge supply and relatively weak fluid milk utilization and high cheese and butter production. Why are regional prices equal or inverted?

Answer:

The April 25,2003 Hoards Dairyman article on mailbox prices answers this question. For the Northeast the federal market order blend price for milk in 2202 was $12.65 per cwt. but deductions for hauling and other services offset any premiums that farmers received and REDUCED their milk price by 76 cents to $11.89 per cwt. In the upper Midwest one starts out with a lower federal market order blend price, $10.98 per cwt. but premiums INCREASED the mailbox price to $11.87 per cwt .

The following conclusion is unavoidable. Midwest farmers prices are higher and effectively equal to Northeast prices because their cooperatives and state/federal policies

generate premiums that offset the legislated lower federal milk-market order minimum prices for their region This is direct evidence that Northeast processors and retailers are taking advantage of Northeast farmers. They have not paid comparable premiums to help the farmer weather this low price environment as the upper Midwest dairy manufacturers and fluid processors have. As a result in the Northeast, a higher cost of production area, a substantial chunk of desperately needed gross farm income as well milk has flowed off farm.

Alternatively farm organizations, cooperatives, and public agencies have, but for the Northeast Dairy Compact in New England (1997-2001), not created as strong a pricing environment for raw milk in the northeast as exists in the upper Midwest.[1]

Question:

Why pass a Fair Share Price Law that links retail, wholesale and farm prices? Isn't the low farm price problem really just a problem of oversupply of milk at the farm level?

Answer:

[1]Our experience with the Dairy Compact illustrate in a powerful fashion how the New England farm interests used it to achieve exactly the same price impact that farm and cooperative interests in the Chicago Class 1 market achieved. The Chicago over-order premium over the July 1997 to July 2000 Compact period averaged 16 cents per gallon. Permit us to compare Chicago and New England raw milk pricing during that same period. In Chicago the federal market order Class 1 price for the period averaged $1.23 per gallon. In New England it averaged $1.39 per gallon, 16 cents more than Chicago. These are averages of the Congressionally mandated minimum prices for Class 1 milk in these two markets. Note that cooperative premiums in Chicago offset the full amount of the Boston Class 1 differential.
In New England, absent the Compact, we estimate that cooperative premiums during the July 1997 to July 2000 period would have elevated price only 6 cents per gallon. With the Compact, the raw milk price was actually increased 16 cents per gallon from $1.39 to $1.55. When viewed from this perspective the Compact offset the Chicago cooperative premium and preserved the Congressionally mandated Class 1 differential between Chicago and New England. The Compact's impact was more powerful than the New England cooperatives by themselves yet it was only commensurate to the impact of the Midwest cooperatives. The Compact also redistributed the 16 cent average premium to concentrate it in periods where milk prices were low. The Chicago premium was uniform over time. Thus the Compact tended to stabilize raw milk prices compared to the Chicago premium. Nearly all farmers prefer this sort of stabilization because it produces a smoother cash flow over time. The proposed fair share law will produce a similar stabilization of farm price because it gives processors and retailers incentives to pay over-order premiums when farm prices are low.

Oversupply of milk at the farm level is in relation to demand for milk at the farm level. Farm level demand is in turn critically related to the prices consumers pay for milk and milk products.. Derived demand prices for fluid milk at the farm level depend not only on the retail price they also depend on the margins that processors and retailers take from retail prices. Our research shows that Connecticut supermarket retailers charge $3.10 per gallon and keep $1.49 for retail services and profits. Processors keep 58 cents per gallon and farmers are left with $1.03 per gallon. The retailer's margin is simply too high. Research in Maine, New York and Pennsylvania documents that in store costs and a reasonable profit for retailers requires somewhat less than 50 cents per gallon(See Cotterill et al., April 23,2003, references and appendix D, for discussion and cites to these studies). Lower retail prices would expand demand in Connecticut, but given the way milk is priced in the federal milk market order system, increased demand would not improve Connecticut farm milk prices much. Therefore, we propose linking raw milk (farm) prices to wholesale and retail prices to get farm prices up from 25 year lows.

Question:

Who is exercising what the proposed Connecticut law (and the N Y price gouging law) identify to be "unconscionably excessive pricing"?

Answer:

As the above answer indicates in Connecticut and more generally New England, the unconscionably excessive exercise of market power is concentrated at the retail stage of the market channel. Leading supermarket chains, with the exception of De Moulas, are

the primary movers behind the high retail price levels relative to wholesale and farm prices that have plagued the milk market channel since December 2001.

See Cotterill et al., Nov. 19, 2002, and April 23, 2003 for detailed documentation. Here we give a few egregious examples of unconscionably excessive pricing. Shaws charges $3.69 per gallon for all types of Hood milk (whole, 2%,1%, and skim). This flat pricing ignores the fact that Hood charges them lower prices for milk with less butterfat content. Retail prices are not cost based as one would expect in a competitive market. Also we have an estimate of the wholesale price that Hood charges from an industry price reporting service, Dairy Technomics. Hood pays farmers $1.03 per gallon on average for the 4 types of milk and charges another 64.2 cents per gallon for processing and delivery into each store's milk cooler. THIS MEANS THAT SHAWS KEEPS $2.00 PER GALLON FOR IN STORE SERVICES AND PROFITS. INSTORE SERVICES COST AT MOST 40 CENTS PER GALLON. Stop and Shop keeps $1.91 per gallon on Hood milk. Across all chains and all brands including private label milk the retailers are keeping roughly $1.50 per gallon. (See Cotterill et al. April 23, 2003, Figure 3 and related text.) This certainly could be defined as unconscionably excessive margins and pricing.

Question:

Would the proposed law help milk processors rein in excessive charges by retailers for the distribution of their milk?

Answer:

Yes.

Question:

Why not ignore the derived farm level demand side and focus on supply control as the National Milk Producers Federation proposal does?

Answer:

If the NMPF proposal works, farmers pay 18 cents per hundredweight to remove supply from the U.S. milk market (2.7% of milk production is the target) to raise price. If this program works, farmers will receive $0.82 per hundredweight more for their milk (Mueller, 2003). Let's assume that it does work and prices are up by that much. Is it enough for New England, a high cost production region? We doubt that it is. Using the January 2003 mailbox price of $11.62, adding $0.82 yields $12.44. Alternatively, if we use the Federal Market Order One blend price for March 2003, $11.43, and again add $0.82, this is only $12.25. These prices are clearly not high enough to cover the cost of production in Connecticut or many other states.

Question:

Is there anything else that we can do to raise farm price?

Answer:

Yes. Milk pricing over the past 85 years has used another pricing instrument in addition to aggregate national supply control to generate higher prices for farmers located in high cost areas that are close to high fluid consumption areas such as the densely populated urban Northeast. That instrument is pricing of milk according to class of use. Milk used for fresh drinks, fluid milk, has been priced higher than milk used for cheese

and butter because consumer demand for fresh drinking milk is less flexible. In economic terms this inelastic demand means one can charge a higher price and not lose many sales. Consumers are willing to pay the higher price for a steady and convenient supply because fresh fluid milk is perishable and an essential part of a healthy diet.

Two points follow. First is the traditional answer that has held for 85 years. Even if the total milk supply is "long" one can raise farm prices by elevating the raw fluid milk price. Because consumption does not decrease much, higher prices generate higher farm revenues. Even when the "long" or excess milk is sold in the "more elastic" cheese and butter markets, farm revenues for sale across both classes of milk increase.

The second point is that times are changing in a fashion that threatens this farm milk price enhancement logic. Traditionally only farmers through the federal government's market order system have been allowed to use and benefit from this exploitation of the inelastic demand for fluid milk. Moreover, the U.S. Congress has legislated exactly how much federal orders can extract from fluid consumers.

Recently, pricing of fluid milk has changed in a radical and non-competitive fashion. The concentration of milk processing in many regional milk markets and the concentration of supermarket retailing in many local food market areas has given private firms the ability to exploit the inelastic fluid demand for milk. As they raise price for their benefit consumer demand becomes more elastic and there is less "water in the well" for farmers via the market orders. In Connecticut a competitive market channel would allow retailers to capture 40-50 cents per gallon, not $1.50 per gallon.

Look at it this way. If that extra dollar were paid back to farmers, retailers would enjoy somewhat more than competitive profit levels, and farmer's price per

hundredweight for fluid milk would go up from $13.25, the federal order minimum at Boston to $24.85 per hundredweight. This is far more than what a farmer needs and far more than the government would ever allow a market order to charge. Under the federal market order system one would never elevate fluid prices this much but private firms exercising market power in Connecticut now do.

Times have changed. Over the past 20 years, and especially since the 1996 freedom to farm law, the federal government has relaxed federal milk market regulation, allowing "market forces" to dictate prices. This has not benefited consumers or farmers as much as envisioned because in this new regime, private market power has substantially decreased competition in markets.

Given the federal relaxation and the changing structure of the milk marketing channel there is a need for new state level regulatory policy initiatives. State level milk policy can address state level issues such as the promotion of more competitive pricing of milk and it can redistribute milk channel income towards farmers, and consumers.

The proposed fair pricing law does exactly that. It creates price collars that give processors and retailers incentives to raise raw fluid milk prices and to cut retail prices. It regains the more stable and higher farm prices relative to farm costs that market orders created throughout much of the 20th century. The proposed policy also restrains consumer milk prices and restores more competitive marketing margins at retail in the channel.

Federal market orders have never addressed channel firm margins and retail prices, but for their continued survival something like the proposed Connecticut price collar law must be done in noncompetitive market channels. Otherwise high retail prices

shift consumers towards the more elastic portion of their demand curve and milk market orders can no longer exploit inelasticity to elevate farm prices.

Question:

Why can't the federal government use the market order system to elevate farm prices?

Answer:

The answer is so important that we restate it in more succinct form here.

The federal government could do so, but over the past two decades Congress has directed it to move in the opposite direction. The result has been higher price volatility and lower milk prices for farmers. Even if the federal government did raise fluid prices, one would still face the newly gained market power of channel firms in many local markets such as New England urban areas. One would have public exercise of market power by the government for farmers and private exercise of market power by channel firms. This is an entirely new pricing problem that market orders or dairy compacts cannot solve. One needs a vertical channel pricing rule such as in the proposed fair pricing law. The price collars in the proposed fair pricing law eliminate what economists call double marginalization. Private market power is constrained and channeled to the public good by the price collars. Price collars give profit seeking channel firms incentives to elevate raw milk prices paid farmers and incentives to reduce retail prices paid by consumers.

It also is very important to stress that the price collars do not prevent channel firms from making a profit and do not force any firm out of business because of losses on milk sales.

Here is an agricultural analogy. The price collars are the working core of a harness that hitches the retail and processor horses to the farmer's wagon. The horses pull that wagon when they elevate price and earn profits but the "drag" of the farmer wagon limits how much the retail and processor elevate retail prices.The drag benefits consumers. If one prefers economics and a mathematical proof of this proposition for the New England milk industry, see 'Appendix D of Cotterill et al (April23,2003).

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