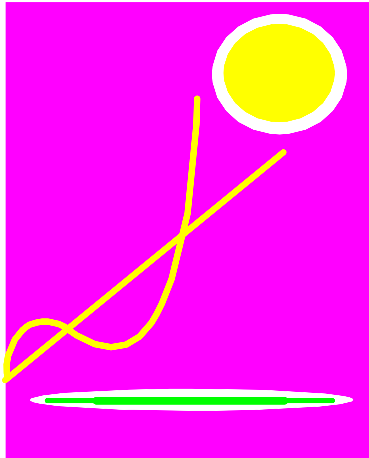

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# Food Marketing Policy Issue Paper

**No. 38** **May 2003**

## Drafting a Connecticut Fair Milk Pricing Law: A Meeting the Competition Clause that Enhances the Competitive Position of Connecticut Processors and A Small Account Rule that Recognizes the Higher Cost of Supplying Such Accounts

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# Drafting a Connecticut Fair Milk Pricing Law: A Meeting the Competition Clause that Enhances the Competitive Position of Connecticut Processors and a Small Account Rule that Recognizes the Higher Cost of Supplying Such Accounts

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## I. Introduction:

There is substantial concern in the state about the economic health of our two remaining independent milk processors, Guida-Seibert Milk Company, New Britain; and Marcus Dairy, Danbury, Connecticut. Some Connecticut farmers are also exploring the possibility of constructing a new cooperative fluid milk processing plant. Farmers and consumers also prefer a milk channel that is effectively competitive-a milk channel with the services of several processors is desirable. Farmers seek continued access to fluid milk processing in southern New England for their milk.

Shipping raw milk to New York for processing and then bringing processed product back to Connecticut puts Connecticut farmers and consumers at the far ends of the distribution channel rather than at its center. Both could lose in this arrangement. The dairy industry also generates jobs and economic activity in the state that would be lost if dairy farms and processing shift west. Recent retail pricing patterns in Connecticut effectively guarantee that even if wholesale milk prices were lower, and there is absolutely no guarantee that they would be if dairying and milk processing shifts west, retail milk prices would not be lower.

For these reasons there is a critical need for the proposed milk pricing law and, as explained in this briefing paper, a need for a meeting the competition clause in the law. As we will show below, the law and this clause forms the core linkage in a vertical strategic alliance between farmers, Connecticut's existing processors and any other processors located in the Northeast who would compete in Connecticut with the nation's and northeast region's dominant vertical strategic alliance Dairy Farmers of America/DMS, and the Dean/Garelick processing system.

## II. Meeting the Competition Clause

We propose the following language. Any processor shall be permitted to mark wholesale milk price up 150% over the raw milk price paid for said milk provided that this processor can demonstrate that the resulting wholesale price is to meet a price offer that is lower than what this processor must charge under the law's 140% collar to cover his reasonable costs of processing and distributing milk. Such costs would include a reasonable return on capital and may be adjusted for allowances for delivery to small accounts.

The impact of this language is as follows. Dean/Garelick is the low cost processor. They process and deliver gallons of milk for 61.6 cents plus raw milk costs to chains other than Stop & Shop, which has negotiated a deal that Dean/Garelick could not afford to give to any other buyer.[1] To honor the 140% wholesale price collar and cover these costs, Dean/Garelick would need to raise the raw milk price to $\frac{.616}{.4} = \$1.54$. Since their current raw milk price is $1.03 per gallon farmers receive a 51-cent premium. Their resulting wholesale price would be $1.54 + .616 = $2.156 per gallon.

[1] All price and margin data in the paper come from Cotterill et al., April 23, 2003. For a copy, go to our web site, http://www.are.uconn.edu/fmktc.html, click on "Price Gouging." It is in the first section.

Now consider Guida's supermarket sales. Its cost of processing and delivery is \$ .658. Honoring the 140% collar and covering their costs means that Guida needs \$1.645 + \$ .658 = \$2.303 as a wholesale price.

Before the law Guida was at a 65.8 – 61.6 = 4.2-cent disadvantage relative to the Garelick/Dean Franklin, Massachusetts plant. Post-law if there is no meeting the competition clause Guida is at a higher 14.7-cent disadvantage.

The 150% collar addresses this issue of competitive disadvantage as follows. Applying the collar means that Guida can pay $\frac{.658}{.5} = 1.316$ to farmers. This means that it can cover its current 62.25-cent processing and distribution margin by selling milk at a price as low as \$1.974 per gallon. This result is due to the fact that Guida's over-order premium to farmers is now only 27.8 cents per gallon over a raw milk price of 1.038 per gallon (Cotterill et al., 4/9/03, Table 3).

At the 140% price collar the farmer premium was \$1.645 - \$1.038 = \$.607 per gallon. The proposed law, however, permits Guida only to match the competitor's price at \$2.156 per gallon. Under the 150% markup rule this implies a raw milk price of \$1.437 per gallon and a raw milk over-order premium of \$1.437-\$1.038 = \$.399 per gallon.

**III. Adding a Small Account Adjustment**

Guida also has small account sales to retailers that are not as large as supermarkets. Rather than analyze them let's apply our proposed small account rule to Marcus Dairy, an operation whose Connecticut sales are almost exclusively to such retail outlets. According to Dairy Technomics, Marcus Dairy's "general wholesale" cost of processing and distribution total 70.6 + .033 = 73.9 cents. The .033 is raw milk costs that

are not paid to the farmer. Distribution accounts for 23.6 cents of this amount. The Connecticut Milk Board will need to make an adjustment for high cost delivery to small accounts by Marcus and other processors. One way to do it is to use the Guida delivery cost to chain supermarkets as a benchmark delivery cost. It costs Guida 17.6 cents per gallon to truck large lots of milk to supermarkets. Since Marcus general wholesale delivery to small accounts costs 23.6 cents per gallon the difference is 6 cents per gallon. Therefore, restating Marcus Dairy to a supermarket equivalent one has 67.9 per gallon. One then would apply the 140% price collar to this amount to determine the premium that Marcus would have to pay farmers if it wants to earn the same dollar margin post-law that it earns today. The raw milk price is $\frac{.679}{.4}$ = 1.698, and the raw milk premium is 1.698 – 1.038 = $ .66. The Marcus wholesale price would be 1.698 + .679 + .06 = $2.437 per gallon. Before the law Marcus was at a (1.038 + .739) – (1.03 + .616) = $ .131 cost disadvantage relative to Dean/Garelick chain store delivery. Now after the law the Marcus cost disadvantage is $2.437 – 2.156 = $ .281.

The meeting the competition clause 150% price collar gives Marcus relief as follows. Applying this collar rate means Marcus can pay farmers $\frac{.679}{.5}$ = $1.358 per gallon. This means that it can cover its current processing and distribution margins ($.679 + $ .06 = $ .739) by wholesaling milk at $2.097 per gallon. This result is due to the fact that the Marcus over-order premium to farmers is now only $1.358 - $1.038 = $ .342 per gallon.

The proposed meeting competition clause would, however, only allow Marcus to match the competitor's supermarket delivery price at $2.156 per gallon. For Marcus the

corresponding raw milk price that honors the 150% collar is 2.156/1.5 = $1.437. It gives Marcus 71.9 cents, which is more than the Marcus cost of 67.9 cents. Adjusted for the added cost of small outlet delivery (6 cents) the Marcus wholesale cost is $2.216 per gallon. Since Dean has similar higher costs delivering to small stores, the proposed law allows Marcus effectively to match the Dean/Garelick price offer.

**IV. Summary and Overview**

The proposed meeting the competition clause can enhance the ability of higher cost processors to compete with a low cost firm that would cut price. After the law Guida can match Dean/Garelick's chain supermarket wholesale price whereas it previously had a 4.2-cent per gallon cost disadvantage. After the law Marcus in its small account general wholesale operation can also effectively match Dean/Garelick compared to a pre-law 13.1 cent cost disadvantage relative to Dean Garelick's large account (supermarket) delivery. The meeting the competition clause allows Guida and Marcus to compete more effectively against Dean/Garelick because farmers via the law receive lower premiums than they otherwise would.

The meeting the competition clause benefits farmers in the long run because without it Guida and Marcus under the law would not be able to compete and survive. With the meeting the competition clause they are able to compete more effectively than they do today. The law actually promotes dairy processing in Connecticut and the region if plants elsewhere take advantage of the meeting the competition clause. This has to be good policy for the state's dairy farmers over the long run.

Note that this policy also makes it easier for new processing facilities, possibly organized by farmers to survive and succeed.

Note also that this clause does not favor processors in Connecticut over processors located in other states that sell in Connecticut. Any processor, regardless of location, can use the meeting the competition clause. Note that even Dean/Garelick can use the meeting the competition clause if another processor such as Midland Farms is willing to sell milk at wholesale price below $2.156. This means that a series of meeting the competition events could wipe out farmer premiums. In effect we revert to the wholesale price and raw milk price situation that would hold if there were no law. What is to stop this from happening?

Under the law retailers will have less incentive to seek “low ball” price offers from processors because their retail price markups are limited to 130% of the wholesale price. The retail collar aligns retailer, processor, and farmer preferences. All prefer higher raw milk and wholesale prices. This means that there may not be many meeting the competition exemptions. The low cost processor, in fact, may elevate its wholesale price (and linked farmer premiums) to the level of the marginal high cost processor, rather than the high cost processor going down via the meet the competition clause.