



Food Marketing Policy

Issue Paper

Food Marketing Policy Issue Papers address particular policy or marketing issues in a non-technical manner. They summarize research results and provide insights for users outside the research community. Single copies are available at no charge. The last page lists all Food Policy Issue Papers to date, and describes other publication series available from the Food Marketing Policy Center.

Tel (860) 486-1927

Fax (860) 486-2461

email: fmpc@uconn.edu
<http://www.fmpc.uconn.edu>

No. 34

March 2003

Fair Pricing Mechanics

by

Ronald W. Cotterill

Food Marketing Policy Center
University of Connecticut

Food Marketing Policy Center, Department of Agricultural and Resource Economics,
University of Connecticut, 1376 Storrs Road, Unit 4021, Storrs, CT 06269-4021

Fair Pricing Mechanics

by

Ronald W. Cotterill

March 19, 2003

**Food Marketing Policy Center
Department of Agricultural and Resource Economics
University of Connecticut
Storrs, CT 06269-4021
Tel: (860) 486-2742
Fax: (860) 486-2461
Email: Ronald.Cotterill@uconn.edu**

Website: <http://www.are.uconn.edu/fmktc.html>

The author is director of the Food Marketing Policy Center in the Department of Agricultural and Resource Economics at the University of Connecticut, Storrs, CT.

Fair Pricing Mechanics

General Concept:

Let's look at a 200% price collar, that is the retail price can be no more than twice the raw fluid price paid to farmers. (Mass. Bill)

Assume:

The retail price is \$3.00 and the raw price is \$1.00 per gallon (near today's situation).

To comply, the channel firms can:

- 1) Cut the retail price to \$2.00.
Note: This leaves them \$1.00 margin.
- 2) Raise the farm price to \$1.50 by paying a 50¢ over order premium (O.O.P.)
Note: This leaves them \$1.50 margin.

Conclusion:

Under this policy processors and retailers will raise raw price by paying over-order premiums.

Fair Pricing Mechanics

Homogeneous Product Case

All processors sell milk as a commodity—No brand premiums.

Now let's look at the Connecticut Bill's 140% price collar for processors.

The market has 3 major processors: Guida, Garelick and Hood. We assume that their processing costs per gallon are:

Hood	60 ¢	(The milk Commission
Guida	55 ¢	will need to measure these.)
Garelick	50 ¢	

We assume RAW PRICE = \$1.00

Now in the market place the wholesale price is set by the marginal (the high cost firm) and others capture rents.

$$P_{\text{wsale}} = \$1.00 + \$.60 = \$1.60$$

Under the fair pricing bill these processors can charge no more than 140% of the raw price. At \$1.60 per gallon they are in violation.

To comply: The marginal processor must raise raw price to $\frac{.60}{.4} = \$1.50$ by paying farmers a 50¢ O.O.P.

Wholesale prices move up to $\$1.50 + .60 = \2.10 for all firms. Each of the other firms captures \$.60 and continues to do better than the marginal firm. They continue to earn rents.

NOTE: The two lower cost firms will not try to cut the O.O.P. If they did they would earn a lower dollar margin.

Fair Pricing Mechanics

Branded Milk Case

Now the firms sell brands, their costs include cost of branding, and their wholesale prices are different.

	<u>Initial Raw Price</u>	<u>Target Margin/.4</u>	<u>Raw Price Needed to Comply</u>	<u>Over Order Premium</u>	<u>Wholesale Price</u>
Hood	\$1.00	$\frac{.60}{.4} =$	\$1.50	\$.50	\$2.10
Guida	\$1.00	$\frac{.55}{.4} =$	\$1.375	\$.375	\$1.925
Garelick	\$1.00	$\frac{.50}{.4} =$	\$1.25	\$.25	\$1.75

1) How do we pay farmers the O.O.P.?

- ❖ Market wide pool (if equal mkt. shares O.O.P. = \$.375) and need to blend with manufacturing milk??
- ❖ Handler pools: Farmers that sell to a processor get his raw price.

Note 1: If pool breakers go to Hood then co-ops may be able to bargain for and get \$1.50 raw price (50¢ O.O.P.) from the other two.

Note 2: BUT also have manufacturing milk issue.