October 19, 2003

Dick Groves, Editor
The Cheese Reporter
2810 Crossroads Drive, Suite 3000
Madison, WI 53718

Dear Dick:

Your story in the Cheese Reporter, September 26, 2003, titled, "Controversy Over Level Of Farm Versus Retail Milk Prices Continues" is an excellent analysis of our recently released price survey and the John Schnittker critique of our earlier April 23,2003 report to the Ct legislature. John's report was a consultant study for the Mass Food Distributor's Association and was released at the Sept 4th hearing held by the Mass Legislature's Committee on the Environment and Agriculture. I also testified there with Secretary of State Galvin (please see our website http://www.fmpc.uconn.edu for that written testimony, John's report, my initial written response to it, and related Boston channel TV news videos. We are very pleased to be able to provide videos and radio pieces on line for viewing).

In this letter I will respond to Schnittker's main criticisms and comments on milk pricing, current milk price policies, and proposed milk price policies in the Northeast.

The proposed Mass price gouge law is the same as the current NY price gouge law that has been in effect for 12 years. JS incorrectly maintains that the 200% retail price collar applies to the class 1 fluid milk price. In fact in both the NY law and the proposed Mass law the language is identical and very clear. The price collar is "when the retail price of fluid milk exceeds two hundred per cent of the farm price for class 1 fluid milk" (Mass bill, available on our website, NY law also there for comparison). The farm price for class 1 fluid milk is NOT the announced FMMO minimum price. It is that price plus any premiums paid to the farmer (both laws consider a cooperative that sells milk to a processor to be a "farmer"). Thus Schnittker's "current market" example loses its punch. He says the class 1 price is $1.20 so the threshold price is $2.40, but it is not because in his example there is a 12 cent per gallon over order premium. The threshold in fact is $2.64, which is above his estimated costs of $2.62 per gallon (farm price of $1.32 +processors cost of 85 cents per gallon + retailers cost of 45 cents per gallon). Schnittker errs. The proposed law does not bind in the current market.

Moreover, Schnittker's calculation of the total channel cost of bottled milk is inflated. He does not recognize that the farm price in these laws is for 3.5% butterfat milk and bottled milk has at most 3.25% butterfat (whole milk). Most milk sold is 2%, 1% or skim milk. Processors sell the excess cream and the value of it should be subtracted from his estimated cost of $2.62 per gallon. I estimate that the price reduction for sale of excess cream is approximately 17 cents per gallon so Schnittker' s correct cost per gallon is $2.62 - $.17 = $2.45. This is very near to the price that De Moulas Supermarkets and Wal-Mart charged. (See our most recent price study for June 2003) Note that Schnittker's total channel cost estimate, when corrected for sale of excess cream, is far below the retail prices charged by all other supermarket chains in New England. Those prices are routinely above $3.00 per gallon. Schnittker is silent on the discrepancy between his cost estimate and documented retail prices that are much higher.

The price gouge gap is even wider in this example. Schnittker's retailing cost is reasonably accurate, however his costs for processing and delivery into supermarkets are not. Dairy Technomics, a firm that is in the business of estimating processor costs to help supermarkets bargain for and monitor wholesale milk prices, finds that they are around 60 cents per gallon. Selected Dairy Tech estimates for Hood, Guida and Dean/Garelick milk , the big three processors, have been verified by the companies themselves or by an independent audit by Price Waterhouse (See my Preliminary Response to Schnittker on our web site)

In conclusion, when corrected for sale of excess cream and over estimation of processor costs Schnittkers "current market example", which appears to be for some month prior to the September 2003 run up in raw fluid milk prices, nicely illustrates that retail prices are unconscionably excessive because they generate gross profit margins far above wholesale delivered milk and in-store costs for retailers.

Schnittker also misses two critical points. First both the NY and the proposed Mass law give retailers an out. They can justify a retail price that is higher than the threshold price by documenting that it is due a high wholesale price paid to a processor and/or high in store costs such as labor or rent or utilities. If such costs account for a retail price above the threshold then the store is not in violation. These laws only go after excessive net of cost profits at retail. Second, the price collar rate at 200% is not set in stone. It can be changed if it generates a large number of investigations that in fact are cost justified.

Schnittker incorrectly maintains that the NY and the proposed Mass law gives retailers incentives to pay higher wholesale prices with guidance that they be paid back to farmers as over order premiums so that the threshold price level will increase. Schnittker clearly contradicts himself here. In the above numerical example he maintained that the threshold price was only based on the class 1 price. Now he would correctly base it on the FMMO minimum class 1 price plus any over order premium. But Schnittker ignores the cost justification out that retailers have. If their costs are above the threshold all they must do is say so. They don't have to pay over order premiums to farmers to elevate the threshold. In the 12 years that the NY law has operated no retailer has ever even attempted to pay over order premiums for this reason.(See NY Ag and Markets Charles Huff's report on the operation of the NY law on our website)

This brings me to a basic and critical difference between the proposed Ct price collar approach the NY/Mass approach. The latter is a pro consumer approach that limits excess retail profits by lowering retail prices. Our pricing studies and Huff's review of the NY law demonstrate that this approach works. A little history is instructive here. In 1991 when the NY price gouge law was passed it was the consumer/downstate component of two bills that were linked for passage. Upstate rural interests wanted and received an over-order pricing law that empowered the NY Dept of Ag and Markets to elevate farm prices when they are extremely low as they were in 1990 and 1991 (and as they were from Dec 2001 to Sept 2003). According to Huff the cooperation (logrolling) of farm and consumer interests (upstate and downstate interests) effectively ensured rapid passage of both bills. The problem, however came later when the over order pricing law was challenged in court and declared unconstitutional. Farmers lost their side of the policy solution to the low farm price and high consumer price milk problem.

Today the Connecticut proposal is an attempt to redress the farmer side of the milk price policy problem. Schnittker is correct when he says that the 140% price collar on processors will give processors incentive to raise farm price via payment of over order premiums if farm prices are so low that the 40% markup will not cover their costs. But this is true ONLY IF they want to avoid losses. Processors have a choice: either suffer right along with farmers when farm prices are low, or pay over order premiums until the collar no longer binds.

In the CT proposal retailers would be permitted to markup wholesale delivered prices only 130%. Given processors costs are approximately 60 cents per gallon the 140-% wholesale markup rule incents processors to pay over order premiums to raise the raw milk price for milk that actually goes in the bottles to $1.50 per gallon (This is $17.43 per cwt, and the payments to farmers for the excess cream up to 3.5% butterfat would add approximately another $1.97 per cwt in our April 2003 example. The policy's parameters can be adjusted to target any desired level of farmer support). With raw bottling milk priced at $1.50 per gallon the resulting wholesale price would be $2.10 per gallon so the 130% retail rule allows retailers to price as high as $2.73 per gallon. Note that this price is well below current retail prices in New England (over $3.00 per gallon). In conclusion, the CT approach raises farm price and lowers retail prices. BUT, retailers still get to keep 63 cents per gallon, an amount well above Schnittker's 45 cent retail cost per gallon. Most, but not all, of current retail profits are redistributed to farmers and consumers.

Schnittker fears that the CT proposal will set off a price spiral that will benefit farmers, processors and retailers at the expense of consumers. We too worried about this and carefully analyzed the post law equilibrium in Appendix D of our April 23,2003 report. Schnittker apparently failed to read it, for he never mentions it. There we demonstrate that the 130% retail price collar increases the effective store level own price elasticity of demand 4.33 times. This "flatter" effective demand really puts a damper on the price spiral hypothesis.. Stated otherwise, we demonstrate in Appendix D that for observed market values of retail and processing cost for input factors other than milk, profit maximizing retailers and processors will in fact behave as in the example given above. Farm price will increase and consumers will pay less.

Schnittker's concludes that the Cotterill proposal "is misguided and should be viewed as uneconomic and inefficient way to deal with low milk prices at the farm level".
We beg to differ. The CT price collar approach attacks demonstrated allocative (pricing) inefficiency in northeast milk marketing channels by bringing channel costs at each stage (and especially the retailing stage) more in line with cost of production and distribution. As such it is an entirely new approach to milk policy, one that puts farmers in a

progressive position of promoting channel pricing efficiency rather than looking for a higher price at the farm gate devil-be-damned what happens downstream. For what happened downstream during the recent 21 month period of extremely low farm milk prices see Policy Issue Paper No 40 (on our website) or the report on it in the September 12, 2003 Cheese Reporter, p. 14. Public power via the market orders, according to an Iowa State study raises retail milk prices about $1.50 per cwt, whereas our research documents that private market power exercised by retailers generates unconscionably excessive net profit rates and raises retail milk prices $1.00 per gallon or $11.60 per cwt. A policy that reigns in this excessive exercise of private market power in the milk channel can elevate farm fluid milk prices several dollars per cwt and still cut price to consumers. A farmer consumer alliance such as was achieved in New York in 1991 makes eminent sense for both groups.

Admittedly the CT price collar proposal could raise northeast farm level milk prices. IF the body politic wants to keep dairy farms in the region this is a policy that can help achieve that goal. During its 1997 to 2001 lifespan the Northeast Dairy Compact helped New England dairy farmers because it effectively restored what Congress wrote into federal market order legislation. Congress mandated a 16 cent per gallon or $3.25 per cwt elevation of the class 1 minimum price for fluid milk at Boston relative to the upper Midwest. Except during the Compact era, recent farm mailbox prices in the northeast have been effectively equal to those received in the upper Midwest because farmers there have more bargaining power and have received significant over order premiums for their cheese milk as well as their fluid milk.

Now if one wishes to prevent the continued demise of dairy farms in the northeast, there is need for some other regional or state policies to once again elevate fluid prices in the northeast - a high cost of production area, but an area that is near densely populated urban areas that need fresh milk. (For more detail on this interregional milk pricing issue see FMPC Issue Paper No 37 on our website in the price gouging section. Also see the story on Ed Jesse's analysis by Ray Mueller in the Sept 12, 2003 Cheese Reporter. Ed recognizes that for some time now cheese milk premiums (and I would add class1 over order premiums necessitated by those cheese premiums to draw milk from cheese plants to bottling) have kept upper Midwest farm milk prices up. Jesse thinks it may be harder to do in the future but he and others are beavering away to find something. Give us Northeasterners the same license please.)

Sincerely,

Ronald W. Cotterill, Director
Food Marketing Policy Center