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HEADLINE: Dairy farmers cull cattle to boost price of milk ;

Producers complain retailers are skimming too much profit

SOURCE: Chronicle Staff Writer

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BODY:

Each day before dawn, and again before sunset, Dennis Leonardi's field hands milk the 350 cows that graze on this idyllic farm in Northern California.

But since late 2001, dairy farmers like Leonardi have been seeing red ink when they gaze on their green fields, as the prices they get paid for raw milk have plunged. Meanwhile, the retail price for consumers has stayed relatively high.

"There's a real disconnect with the retail price," said Leonardi, who inherited the farm from his parents and hopes to pass it on to his children. "Wholesale prices have been low for 18 months, but retail prices haven't."

Although the question of what constitutes a fair markup on milk is open to debate, California Department of Food and Agriculture data reveal a curious fact. While dairies get almost the same prices for raw milk whether they're in Northern California or Greater Phoenix, supermarket prices can vary by as much as a buck from city to city -- statistical proof, farmers say, that they have to swallow prices while retailers get to set them.

This spring, for instance, when the farm price of milk was just above \$1 per gallon, retail prices ranged from \$2 in Phoenix to \$3 in Seattle, with the Bay Area in between.

"The farmer is not a pricemaker. The farmer is a price-taker," said Jerry Kozak, president of National Milk Producers Federation, an organization of dairy cooperatives that accounts for two-thirds of the nation's milk.

Now the federation is helping Leonardi and thousands of other dairy farmers organize a nationwide program to boost farm prices by persuading some of them to cull their herds. Kozak said it's the first time dairies have banded together to voluntarily cut production, and thus boost the prices they get paid.

"It's about farmers taking control of their own destiny," he said, "(and) understanding that we can't look for government to help us out every time."

Kozak said the reduction in supply should not affect consumers, because most of the cost of a gallon of milk is earned by middlemen and retailers.

"The spread between what farmers receive for their goods and what consumers pay for them is widening," he said.

But Tim Hammonds, president of the Food Marketing Institute, the national trade association, whose members represent two-thirds of the nation's grocers, argues that dairy farmers already get a fair share of the milk dollar.

"When dairy farmers are facing hard times, they tend to look around and place blame," said Hammonds, adding: "We believe the retail price is a fair representation of the cost of getting (raw) milk into a form and a place where consumers want to buy it."

In March, Sen. Patrick Leahy, D-Vermont, asked the General Accounting Office, the official fact-finding agency of Congress, to look into "the widening disparity between farm and retail milk prices," and report back later this year about the causes of this perceived gap and how it has affected small dairies.

Hammonds, the grocery representative, doesn't put much stock in the request. "That's what senators do," he said, adding "they've done it for 50 years, (and) there has never been a finding of excess retail prices."

Meanwhile, dairy farmers are trying to take the price issue into their own hands. In July, the dairies in the federation voted to pay a voluntary "tax" -- about a nickel on every 11.5 gallons they produce -- into a fund that is expected to collect about \$60 million by next summer.

The federation will use this money to pay farmers to slaughter about 35,000 of the nation's 9 million dairy cattle, and take other steps to cut about 0.07 percent from the nation's milk supply, which is expected to total roughly 19.7 billion gallons in 2003.

The program, dubbed CWT, short for Cooperatives Working Together -- raises two obvious questions: How can producers band together to cut production in the face of antitrust laws; and if the culling program is legal, what effect can this drop in the bucket have on the price of milk?

Dairy farmers have an easy answer to the first question: Farmers were specifically exempted from price-fixing laws under the 1922 Capper-Volstead Act.

"The whole idea Congress had is that there are lots of farmers and few channels into which they can sell, putting them at a disadvantage to the railroads and the processors," said Kevin Brosch, general counsel for the Milk Producers Federation.

Brosch said that court decisions since the 1920s have upheld Capper-Volstead, and that he doesn't

expect a legal challenge to the culling program.

As for the second question, whether a tiny reduction in the milk supply could have any effect on farm prices, a leading milk futures trader in Chicago said he thinks the mere existence of the program has already had an effect.

"Since the announcement of CWT, the (raw milk) market has in fact rallied fairly sharply," said Joe O'Neill, a partner in the Downes-O'Neill brokerage firm.

Data from the California Department of Food and Agriculture, which surveys farm and retail prices on a monthly basis, captured the jump. After averaging \$1.02 per gallon from January through July, the farm price of milk in Northern California jumped to \$1.24 in August, according to agency's figures.

How much of that jump is due to the culling program is difficult to assess, said O'Neill, but he does not expect the big jumps in the farm price to continue. "Now that the program is in place, the psychological factor is already built into the underlying price," he said.

As for how this leap in farm prices will play out on the grocery shelves, Elisa Odabashian, milk market analyst for the Consumers Union in San Francisco, says shoppers have nothing to fear.

"From the consumer perspective, it really doesn't matter what the farm price is," said Odabashian, adding, "What you have over time is this growing gap between what the farmers are paid and what the retailers charge."

An Oct. 2 letter written by David Ikari, chief of the state's Dairy Marketing Branch, provides an encapsulated view of the farm-to-retail price spread since California stopped regulating milk prices in 1978. Retailers "are quick to pass on to consumers" any uptick in the price of raw milk, "but are not so quick to decrease when the farm price decreases."

Ikari also noted that during the past two years, it has consistently cost about \$1 per gallon -- over and above the farm price -- to process, distribute and sell milk. In August, when the Northern California farm price of milk was \$1.24, the average retail price of whole milk in the Bay Area was \$3.09 per gallon, he said.

Odabashian, of Consumers Union, would argue that the 85 cent per gallon difference between \$2.24 -- the farm price plus the processing, transport and selling costs -- and the actual retail price makes milk a very profitable retail product, especially for supermarkets, many of which have their own processing operations and sell milk under their own brand name.

"They won't say it, but milk is a huge profit center for supermarkets," she said.

Peter Larkin, president of the California Grocers' Association, said such complaints don't take into account the fact that milk is "perishable and takes a lot of labor to sell before it spoils."

Added Larkin: "The retail food business is extremely competitive, and consumers are extremely aware of the price of milk."

Hammonds, from the Food Marketing Institute, the nationwide supermarket association, said critics ignore the fact that people can buy milk everywhere, from warehouse clubs and superstores to neighborhood groceries and gas station. Retail prices can't be out of line, given all that retail competition.

As for the farmers' complaints that they don't get enough for their product, Hammonds offered this observation.

"All things considered, there is too much milk here in the country," he said, adding that measures like the culling program, which aim to decrease the supply of milk, are "directionally the right thing to do."

Dairy farmer Anthony Mendes was doing his part to reduce milk output earlier this month, when he used a small subsidy from the program's fund to cull 210 cows from his Fresno County herd. Mendes, who will still milk about 1,550 cows even after the reduction, worked out the math in advance.

He and his family partners, who operate two dairy operations a few miles apart, had been planning to retire the smaller operation at some point anyway. The availability of the program subsidy simply accelerated their decision, and made it a tad sweeter. Mendes figures they earned just a bit more under the program than they would have had they sold the cows on the open beef market, where they would have fetched \$800 to \$1,000 per head.

In a sense, the Mendes example illustrates a critique of the culling program made by nationally renowned dairy economist Ed Jesse of the University of Wisconsin. "The buyout probably rewarded farmers who would have sold out anyway," he said.

But to Mendes, such a criticism misses the point that the program is more about perception and psychology than hard, statistical facts about the number of the nation's dairy cattle and the total output of milk.

"Markets work very quickly, based on emotions and rumors," Mendes said, echoing the observation made by O'Neill, the Chicago commodity broker. In this environment, in which farmers are accustomed to getting whipsawed by farm prices that fluctuate inexplicably, the program is more about the psychology of taking action -- even if it proves futile -- rather than being at the mercy of the market.

"It's that illusion of control that makes you feel good, even if it isn't true," Mendes said.

Meanwhile, on his dairy in out-of-the-way Ferndale, Leonardi said programs designed to help farmers pay a dividend that can't simply be measured in dollars.

"We protect the green space. Nobody else does that," he said. "We keep America looking like it should look."

CHART:

Dairy farmers cite price gap between farm and store

The three lower lines on this chart represent the farm price of raw milk in Northern California, greater Phoenix and the Pacific Northwest. The upper lines show retail prices in San Francisco, Phoenix and Seattle. While farm prices hardly vary, retail prices show a wide regional spread. Farmers say the difference shows that retailers can dictate prices. Retailers say local market variables, plus abundant competition, set shelf prices. State laws also play a

role. In California, retailers cannot sell milk below its production cost. Arizona has no such requirement, which allows retailers to use milk as a "loss leader" to attract consumers.

Average whole milk retail prices May '98

Phoenix	\$2.19
San Francisco	\$2.93
Seattle	\$2.98
July '03	
San Francisco	\$2.93
Seattle	\$3.26
Phoenix	\$2.16

Average farm prices May '98

Phoenix:	\$1.32
Northern California:	\$1.30
Pacific Northwest:	\$1.27
July '03	
Phoenix:	\$1.04
Northern California:	\$1.01
Pacific Northwest:	\$1.00

Source: California Department of Food and Agriculture

Note: Milk prices for Aug. 2001 and Aug. 2003 were omitted due to incomplete data. Prices for July 2003 are for week ending July 12.

Chronicle Graphic

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GRAPHIC: PHOTO (3): CHART: SEE END OF TEXT, (1-2) Dennis Leonardi, a dairy producer in Ferndale, Humboldt County, below, says his farm is in danger of going bankrupt., (3) Dennis Leonardi's farm is part of the CWT program, whose initials recall the hundredweight, traditionally used to weigh milk. / Photos by Adam Traum / The Chronicle

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