The Compact Plus Approach to New England Dairy Policy

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Starting Fact

- New England Dairy Farmers need a blend price that is at least $15 per cwt to cover their cost of production.
- Source: Michael Sciabarrasi presentation and conference consensus opinion, "Northeast Dairy Policy and Prices Summit Meeting," University of Connecticut, November 17-18, 2003.
- OK – if this is our goal how do we get there?

What are the Strategic Options

- Producer/Handler Processing (Mountain Dairy)
- Small Scale Cooperative Processing with Own Brand (Proud Cow, Rhode Island, Very alive idea)
- A New New England Dairy Compact
- The National Dairy Equity Act (5 Regional Compacts)
- The "Compact Plus" Approach
- Fact: All of these seek to capture a higher Class 1 to manufacturing milk price differential. The Class 1 differential in the federal marketing order has been fixed at $3.25 at Boston for over 20 years.

Some Recent History

- The Compact idea was to elevate and stabilize the raw fluid milk price.
- This was to improve dairy farm income and to allow for <u>less</u> risky long run investment planning on farms.
- It also had a pro-consumer component. The idea was as follows: Stabilizing the raw fluid milk price reduces the price risk on the major input for the processing and distribution of milk. Economic theory predicts that a reduction in input price risk will lead to a lower farm to retail price spread.

Some Recent History

- The hope (hypothesis) was that this might offset part or all of the price elevation to farmers.
- Dan Smith, the Executive Director of the Dairy Compact, has recounted that the Compact minimum of $16.94 per cwt ($1.46 per gallon) was set at this level because it only elevated the Class 1 raw fluid minimum price from the January 1996 thru June 1997 monthly average price, $1.40 per gallon to $1.46 per gallon. A 6 cent increase.

Some Recent History

- Fact: After accounting for changes in cooperative over-order premiums (they went <u>down</u> after Compact implementation) the net raw price increase over the Jan 96 – June 97 base period was only 2.7 cents per gallon (see Research Report No. 77 or my written testimony submitted during Compact to the U.S. Senate: FMPC Issue Paper No. 24).
- Fact: Our and other's research has shown that if the compact had <u>not</u> been in force, farmers would have received 10 cents less per gallon ($1.16 per hundredweight). This is the $120 million (+/-) benefit that New England farmers received.

Some Recent History

- Fact: Our research however shows that the channel firms raised the price over time to consumers by much more than the 2.7 cent increase in raw milk. In fact, their margin went up about 13 cents so the total impact on consumers was 13 + 2.7 ≅ 16 cents per gallon.
- Fact: During the compact debate, but for our analysis, all of this increase over time was attributed to the Dairy Compact.

Some Recent History

Concluding Comments From, "The Impact of the Northeast Dairy Compact on New England Consumers: A Report from the Milk Policy Wars."
FMPC Research Report No. 77.

After this review of studies that address the impact of the Compact on New England consumers, several conclusions seem warranted. Contrary to Congressional expectations the Compact did not lower market channel margins and it did not eliminate asymmetric pricing. The Compact however, independent of the reactions by milk channel firms, had little impact on consumers over time. It increased consumers prices less than 1 percent; but, farmers received a higher price than they otherwise would have received due to the Compact's minimum price floor. This in fact was the core rationale for the Compact: not increase consumer prices but limit the ability of market channel firms to capture large increases in their profits (windfall profits) at the expense of farmers when the raw fluid milk price drops.

Some Recent History

Concluding Comments From, “The Impact of the Northeast Dairy Compact on New England Consumers: A Report from the Milk Policy Wars.” FMPC Research Report No. 77.

Clearly the Compact, by itself, did redistribute channel income without significantly affecting consumer prices over time. Other factors, including increased net profit margins, account for 90 percent of the increase in milk prices over time. Only if one attributes the industry’s margin widening price reaction to the Dairy Compact does one obtain a sizable impact of 16 cents per gallon on retail prices over time.

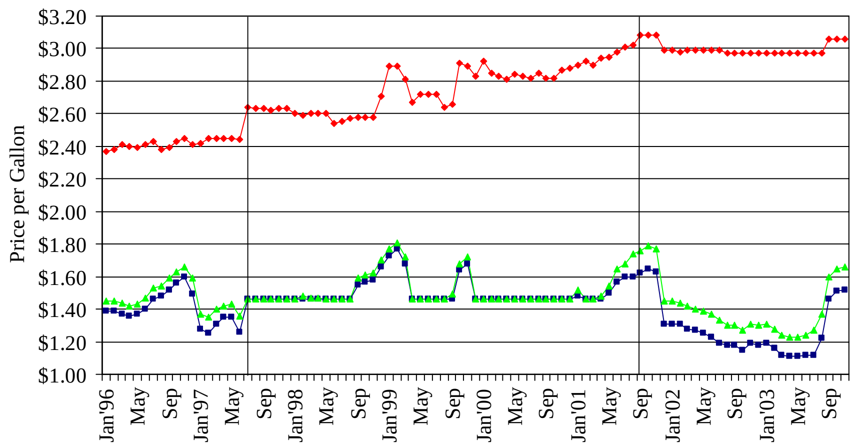
Some Recent History

- Now lets look at what actually happened after the demise of the Dairy Compact.
  - Fact: Raw fluid prices dropped 50 cents per gallon at the onset of the recent milk price depression
  - But consumer prices dropped only 10 cents

    (Aside) Bailey/IDFA Model used to defeat the Compact predicts an 85 cent price drop. That model predicted the Compact caused retail prices to increase 22 cents. Conclusion: The model overshoots and is not accurate.

Figure 1.

Boston
Market Level Retail and Farm Fluid Milk Price
January 1996 – November 2003



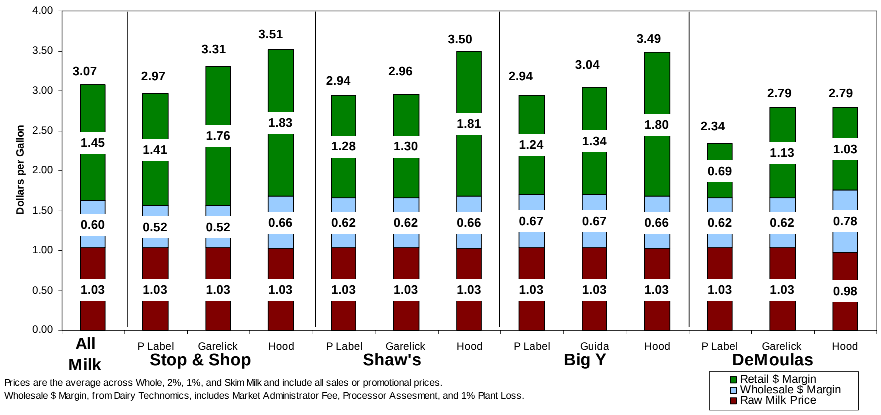
Source: Data from Order One Market Administrator and Dairy Market News

Vertical lines indicate beginning and end of Northeast Dairy Compact

Some Recent History

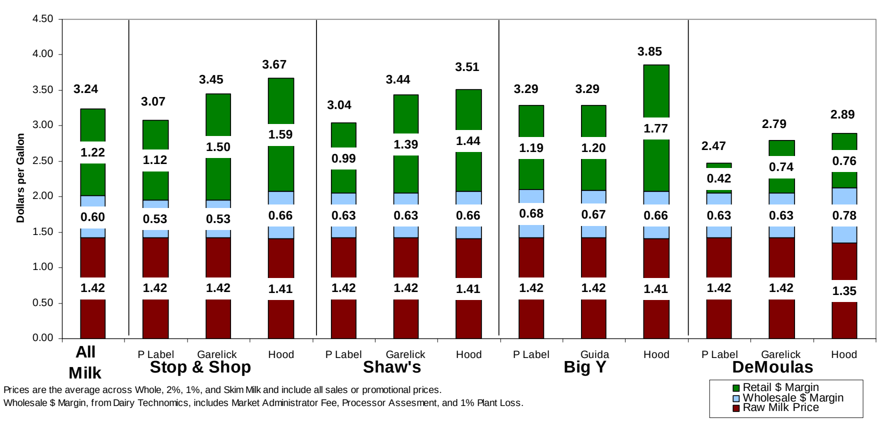
- Conclusion: We suggest a "Compact Plus" Policy
- This program gives the Compact benefit to farmers in the raw milk market.
- And it promotes efficient (competitive) pricing in the market channel.
- This not only prevents "Loading on" of wider channel profit margins to the Compact component as in the past, it also can lower consumer/retail milk prices.
- Lets look at the market to identify the problem an explain how "Compact Plus" works.

Figure 2: Actual Raw Milk, Estimated Wholesale, and Actual Retail Milk Pricing by Brand for the Four Leading Supermarket Chains in Southern New England: June 2003



Prices are the average across Whole, 2%, 1%, and Skim Milk and include all sales or promotional prices.
Wholesale $ Margin, from Dairy Technomics, includes Market Administrator Fee, Processor Assesment, and 1% Plant Loss.

Figure 3: Actual Raw Milk, Estimated Wholesale, and Actual Retail Milk Pricing by Brand for the Four Leading Supermarket Chains in Southern New England: October 2003



Prices are the average across Whole, 2%, 1%, and Skim Milk and include all sales or promotional prices.
Wholesale $ Margin, from Dairy Technomics, includes Market Administrator Fee, Processor Assesment, and 1% Plant Loss.

The Current Milk Pricing Situation in the Northeast

- Fact: During low farm price periods, retail margins become excessive in Southern New England. As they did in Metro New York before the New York Price Gouge Law.
- With the current farm price recovery, retail margins are lower but still excessive.

Policy Options

- Basic Question: Can we devise a policy that reduces the excessive retail margin by raising raw fluid prices paid farmers and lowering retail prices without damaging processors?
- Answer: Yes
- This is the "Compact Plus" policy that we are proposing – it uses price collars.

The Compact Plus Approach: June 2003

- Let's look at how price collars might work for June 2003 – a low farm price month.
- Farmers received $1.03 per gallon for the milk bottled.
- Consumers paid $3.07 and the average processing and delivery cost was 60 cents per gallon.

The Compact Plus Approach: June 2003

- A 140% price collar at wholesale
  - This means that if processors want to cover 60 cents per gallon processing costs, they must raise raw milk prices by paying over-order premiums to $1.50 per gal. (0.40 x $1.50 = $0.60)
- A 130% price collar at retail over wholesale price
  - If processors pay over-order premiums to cover costs, they raise wholesale prices to 1.40 x $1.50 = $2.10 and then retailers are limited to $2.10 x 1.30 = $2.73

The Compact Plus Approach: June 2003

- Result: Farmers in low price fluid markets (Below $1.50) get a price floor at $1.50/gallon ($17.44 per cwt). They also get the value of excess cream that is not in the skim, 1%, 2%, and 3.25% milk. We estimate this is $2.00 so fluid price is $19.44 per cwt.
- Result: Consumers pay $2.73 per gallon. This is below the current price @ $3.07 per gallon in Southern New England.
- Result: Both Farmers and Consumers Benefit

The Compact Plus Approach: June 2003

- Result: Processors have same margin but sell more milk at this lower retail price.
- Result: Retailer's margin is reduced from $1.45 to 63 cents, which is above the competitive market benchmark of 45 cents. (Professor George Criner, University of Maine)

The Compact Plus Approach: October 2003

- How would the law work in October 2003?
  - Farm Price = $1.42
  - Average processor margin is 60 cents
  - Retail Price = $3.24
- To cover 60 cents, processors would pay only a 6 cent premium, bringing the raw milk price up to $1.50
- Wholesale prices would increase from $2.02 to $2.10
- Retail prices would at most be 1.3(2.10)=$2.73 and retail margin is reduced from $1.23 to 63 cents.
- Consumer price drops from $3.24 to $2.73 per gallon.

The Compact Plus Approach: October 2003

- Note the proposed law really benefits consumers when farm prices go up: Here they save 51 cents whereas they saved only 33 cents in the low farm price month.
- Fact: This equilibrium wholesale and retail price will change as processors costs change and processor and retailer pricing strategies deviate from profit maximizing behavior.

Sensitivity Analysis: Heterogeneous Processor Costs – The Need for a Meeting the Competition Clause

- Consider the situation for gallons of milk. The price collar at wholesale is 140% but we propose a 150% collar for any firm that is meeting a competitive offer. Here is how it works.

Sensitivity Analysis: Heterogeneous Processor Costs – The Need for a Meeting the Competition Clause

- Dean/Garelick is the low cost processor in New England at 62 cents per gallon to chains other than Stop & Shop, which has negotiated a deal that Dean/Garelick could not afford to give to any other buyer.
- To honor the 140% wholesale price collar and cover these costs, Dean/Garelick would need to raise the raw milk price to (.62/.4) = $1.55
- Since their current raw milk price is $1.03 per gallon, farmers receive a 52 cent premium.
- Dean's resulting wholesale price would be $1.55 + .62 = $2.17 per gallon.

Sensitivity Analysis: Heterogeneous Processor Costs – The Need for a Meeting the Competition Clause

- Now consider a higher cost processor whose cost of processing and delivery is 66 cents. Honoring the 140% collar and covering costs means that it needs \$1.65 + .66 = \$2.31 as a wholesale price.
- Before the law, the high cost processor was at a .66 - .62 = 4 cent disadvantage relative to the Garelick/Dean Franklin, Massachusetts plant. Post-law if there is no meeting the competition clause, the high cost processor is at a higher 14-cent disadvantage.

Sensitivity Analysis: Heterogeneous Processor Costs – The Need for a Meeting the Competition Clause

- The 150% collar in the meeting the competition clause addresses this issue of magnified competitive disadvantage as follows:
  - The proposed law permits the high cost processor to match the competitor's price at \$2.17 per gallon and use the 150% price collar.
  - Under the 150% markup rule this implies a raw milk price of \$1.45 per gallon, a raw milk over-order premium of 42 cents per gallon, and an increase in the high cost processors margin from 66 cents to 72 cents.

Sensitivity Analysis: Heterogeneous Processor Costs – The Need for a Meeting the Competition Clause

- Note: The meeting the competition clause removes the incentive for the low cost processor to low ball higher cost processors. Consequently, wholesale equilibrium will tend to be determined by the marginal high cost processor. But for whatever reason, if the low cost processor does make a low ball offer they benefit rather than hurt high cost processors.

Sensitivity Analysis: Heterogeneous Processor Costs – The Need for a Meeting the Competition Clause

- Conclusion:
  - The law and this clause form the core for a vertical strategic alliance between farmers, and this region's smaller higher cost processors, possibly including any processing plant started by a farm cooperative, who would compete with the against the Dean/Garelick processing system.
  - Under the law those processors suffer no cost disadvantage and in fact may enjoy increased profitability relative to the "no policy" situation.
  - The Milk Regulation Board would be the center of an industrial policy that could, if it so chooses, promote milk processing as well as dairy farming.

Exemptions

- Retailers with less than 5 stores and total store sales less than $20 Million are exempt.
- Producer-handlers are exempt.
- Processors may collect a surcharge for deliveries of less than 200 gallons to cover added costs.
- Processors may collect a surcharge for added costs of deliveries beyond 100 miles from the plant.

Farmer Pooling

- The proposed law says nothing about over-order premiums. If processors pay them it is up to the farmer cooperatives, Agrimark and DMS/St. Albans, to determine how they would be paid back to farmers.

Single State vs. Multi-State Passage

- If the law is passed in one state, all milk sold at wholesale and retail are covered. If premiums are paid, again, coops would have to determine how to allocate them to farmers.
- If the law is passed in New England States, one would have coverage effectively equal to the Dairy Compact and the old New England Milk Market Order. All wholesale and retail transactions in New England would be covered.

The Wellington Critique: Legal Marketing Issues

- The critical issue is this:
  - Can any processor or retailer legally escape the "Compact Plus" regulation?
  - Robert Wellington says, Yes. The policy violates the Interstate Commerce Clause and related milk pricing case law.
  - Cotterill Response: Consider the following
    - The CT. Attorney General and staff wrote the bill and maintain that it is legal.
    - Moreover, the Attorney General has stated that if promulgated he would defend it.

The Wellington Critique: Legal Marketing Issues

- Last summer, Robert Wellington of Agri-Mark, at our behest, met with the CT. AG. staff attorneys to discuss this. At the end, both sides positions remained unchanged.
- Conclusion: Until Agri-Mark or some other person presents the CT. AG. with a legal brief that convinces the CT. AG. that the proposed policy is illegal, we will follow the AG and state that the proposed policy is legal.
- Some outside observers have stated that my continued insistence that the policy is legal, in the face of Agri-Mark's position, is unprofessional conduct.
- The contrary has to be the case, i.e. professional conduct for an economist, untrained in the law, is to follow the opinion of the CT. AG.

Factual Response to Wellington Examples of How the Law will Fail

- First go to our website, www.fmpc.uconn.edu, click on Milk Price Gouging and locate "Responses to some questions raised at the March 14, 2003 meeting on dairy pricing and fair pricing milk" by R.W. Cotterill – March 19, 2003.
- At that time, Bob raised three concerns that we answered. Now he raises a fourth that we put in that paper stating that it "could be used to circumvent the law." In fact, upon closer reflection this possible "end run" is also prevented by the law.

Factual Response to Wellington Examples of How the Law will Fail

- The attempted "end run" is as follows. Retailers shift to out of state processors or take delivery out of state from those processors who currently deliver milk in state.
- Once the wholesale transaction is out of state, retailers continue to pay a high wholesale price so the 130% collar allows them to charge the same retail price (no price change for consumers).
- The out of state processor's wholesale price in this example is <u>not</u> regulated by CT so the processor does not have to honor the 140% wholesale collar. This means the processor pays no premium to farmers. Moreover, the retailer demands and gets a rebate on other goods in its stores in Massachusetts that restores the wholesale price to its original level.

Factual Response to Wellington Examples of How the Law will Fail

- The result: The multi-state chain retailer with out of state processing has no change in retail, true wholesale, and farm price. <u>But</u>, the instate processor must honor the law, so retailers have an incentive to shift to out of state processors to keep their high profit margin.

Factual Response to Wellington Examples of How the Law will Fail

- How will the proposed law stop this?
  - Answer: The 130% retail price collar is still operative since the milk is sold to consumers in state. The Milk Regulation Board has audit authority and the draft law states:
    Sec. 2. (k) As used in this section, the price charged by the producer or processor shall include the invoice price and all other adjustments to such invoice price, including but not limited to bill backs, discounts, allowances for promotion or advertising and slotting fees.
  - So the Milk Regulation Board can audit and catch the bogus high wholesale price. The retail chains true wholesale price is much lower, so the chain must cut its retail price.

Factual Response to Wellington Examples of How the Law will Fail

- Query: But how does this help the farmer?
  - <u>Well</u>, if the retailer wants to do a "Midland Farms," i.e. go out of state to a low cost processor and retail at a corresponding low price, so be it.
  - Have any of the supermarket retailers done this to date? No. They want to maximize profits on milk, not use it as a loss leader.
  - The retailers incentive is to have a high <u>legal</u> wholesale price so the 130% markup generates profits.

Other Wellington Issues

- We do not dispute the fact that there is substantial political opposition to the “Compact Plus” proposal. But, there also are substantial gains for farmers, consumers, and some processors.
- We also recognize that this is regulation that requires auditing and that it requires a very active Milk Regulation Board with access to economic analysts.
- Finally, there are several smaller points such as Wellingtons use of the 3.5% raw milk price when the law uses the price of milk actually bottled.

Finally Finally

- Nothing is set in stone. The Milk Regulation Board would need to regularly monitor the industry and take actions to implement the policy in a fashion that achieves the boards desired policy goals.
- Recall that the board is comprised of 2 farmers, 2 processors, 2 retailers, and 2 consumers.
- Other Issues