The Proposed Connecticut Price Collar Approach

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by

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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.
- Fact: A New York style price gouge law can reduce excessive margins but all benefits of the price reduction go to consumers. When it was passed, an over-order premium law was also passed but subsequently declared unconstitutional.
- Fact: A Pennsylvania Milk Marking Board approach with a declared over-order premium can benefit farmers but does nothing to reduce excessive margins and consumer harm.

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?
- There undoubtedly is more than one way to do this.
- We are proposing a price collar approach.
- It does <u>not</u> dictate prices, nor does it necessarily result in higher farm prices.
- It changes the incentive structure for processors and retailers, but still allows them to set prices.

The Price Collar Approach: June 2003

- Let's look at the proposed price collar approach 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.

Proposed CT Price Gouge Law: 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

Proposed CT Price Gouge Law: 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.
- 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

Proposed CT Price Gouge Law: 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.

Proposed CT Price Gouge Law: 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.

Proposed CT Price Gouge Law: 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.
- Note that this equilibrium wholesale and retail price will change as processors costs change and processor and retailer pricing strategies deviate from profit maximization behavior.
- See Cotterill, Rabinowitz, and Tian, "A Law to Promote Efficient and Fair Pricing of Milk in Connecticut." Food Marketing Policy Center Issue Papers 35, 36, 38, and the Draft Law for more information.

Sensitivity Analysis: Lower Farm Wholesale and Retail Prices Possible

- Processors and retailers do not have to and may very well not pay premiums that are this high and may charge prices below $2.73 per gallon.
- For example, Club and Limited Assortment stores charged only $2.00 and $1.99 at retail in New England in June 2003. The proposed price collar law does not rule out this conduct.
- Just the same, if firms seek to maximize profits we expect premiums will be paid to farmers.

Sensitivity Analysis: Different Brands of Milk

- The New York Price Gouge Law applies only to the SKUs (stocking units) of the lowest priced brands of milk, usually private label. We proposed this in the April 23, 2003 report and expected retailers to lower brand prices in response to the required lower private label prices.
- Alternatively, one can apply the 130% collar to all brands. This would eliminate the truly excessive retail markups on branded milk products to the benefit of processors, consumers and farmers.

Sensitivity Analysis: Different Type of Milk Skim, 1%, 2%, 3.25%

- One can, and we recommend, applying the 140% price collar at wholesale to the average price of all types of milk since processing and distribution do not vary by butterfat content.
- At retail, one could do the same: i.e. apply the 130% collar to the average price of all types of milk for the same reason. Retailing costs do not vary by butterfat content.

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 competition 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 Guida's supermarket sales. Its cost of processing and delivery is 66 cents. Honoring the 140% collar and covering their costs means that Guida needs \$1.65 + .66 = \$2.31 as a wholesale price.
- Before the law, Guida 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, Guida is at a higher 14-cent disadvantage.

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

- The 150% collar addresses this issue of magnified competitive disadvantage as follows:
  - Applying the collar means that Guida can pay (.66/.5) = \$1.32 to farmers.
  - This means that it can cover its current 66 cent processing and distribution margin by selling milk at a price as low as \$1.98 per gallon.
  - This result is due to the fact that Guida's over-order premium to farmers is now only 29 cents per gallon over a raw milk price of \$1.03 per gallon.

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

- Exampled continued:
  - The proposed law, however, only permits Guida to match the competitor’s price at $2.17 per gallon.
  - Under the 150% markup rule this implies a raw milk price of $1.45 per gallon and a raw milk over-order premium of 42 cents per gallon.
- Note: The meeting the competition clause removes the incentive for Dean to low ball Guida or other higher cost processors (the few that we have left). Consequently, wholesale equilibrium will tend to be determined by the marginal high cost processor.

- Conclusion:
  - The law and this clause form the core for a vertical strategic alliance between farmers, and this region’s smaller processors who would compete with the against the Dean/Garelick processing system.
  - Under the law they suffer no cost disadvantage.

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.