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Outline of a Fair Share Milk Pricing Policy Program As Requested by Carolyn Orr, Council of State Governments after the February St. Albans, Vermont Meeting on Dairy Policy and Prices

by

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Outline of a Fair Share Milk Pricing Policy Program
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March 23, 2006

1) The basic proposition of a fair share milk pricing policy program is the following: Retail milk prices during the low phase of the raw milk price cycle and possibly during the entire raw milk price cycle are high relative to raw milk prices. The large marketing spread is not due to excessive processor margins. It is due to excessive retailer margins. The fair share pricing program will redress the imbalance in prices in the market channel and eliminate part or all of the pricing inefficiency that comes from the exercise of market power by retailers. This pricing inefficiency harms consumers; however, it also harms farmers that receive a price that is below the long run supply price, and it harms processors because they process less milk. The farm level pricing problems of farmers in the Northeast is exacerbated by inter regional distortions in the raw milk price surface as explained in University of Connecticut Food Marketing Policy Issue Paper No. 48 (http://www.fmpc.uconn.edu). Throughout the raw milk price cycle farmers in the upper Midwest and far West are advantaged under current federal milk pricing policies and the activities of state's in their regions. *Hoard's Dairyman* mailbox prices show that farmers in the upper Midwest routinely receive higher prices for raw milk than farmers in the Northeast. This is a price inversion because raw

milk should be higher valued in areas of the country where fluid utilization is higher. Such areas include the Southeast and the Northeast.

Finally, and perhaps equally as important as the economic reasons given above, there is very strong interest in redressing the rural urban imbalance in economic opportunity. In New York downstate citizens have a concern for the preservation of rural upstate New York. The same is true in urban and rural New England. Farmers, their land, and rural farming based communities in New York and New England are a cultural asset worth preserving.

2) The fair share milk pricing policy will reallocate retailer margins by using the following pricing rule: Retailers will be allowed to mark up milk that they receive from wholesalers a certain amount, for example, 20 percent. Any markup over and above this floor amount will be shared with farmers according to a fair share rate, for example, 50 percent. Let us assume the farm price has dropped to $1.25 a gallon for a particular fat content milk, for example, whole milk at 3.5 percent or 3.25 percent butterfat. Also assume that processors' cost is approximately 75 cents per gallon for wholesale milk delivered to the back room cooler of a retailer. This means the delivered wholesale price of the milk is $2.00 per gallon. Under the fair share pricing rule retailers would be allowed to mark it up 20 percent, that is to $2.40 at retail without incurring an obligation to pay money to farmers. If they mark the milk up more than that, for example, to $3.00 a gallon then with a 50 percent share ratio the retailer keeps only 30 cents of the additional 60 cents and pays the other 30 cents into a producer fund for return to the farmers that supply this milk. This effectively raises the producer price from

$1.25 a gallon to $1.55 a gallon. Note it does not affect the processor in any fashion.

3) Fair share pricing can be implemented on a state by state basis in the Northeast. If the Southern New England states and New York joined to do this the program, operated independently in each state, it would effectively cover most of the Northeast milk shed. Adding New Jersey and other New England states would, of course, enhance coverage, as would the addition of Pennsylvania.

Note that there is no free rider problem with this pricing rule and strategy to return benefits to farmers. There is no free rider problem because a retailer cannot avoid payment of the fair share amount into the settlement funds by switching to some other milk supplier. It doesn't matter what supplier supplies the milk, the payment is triggered by the retail pricing behavior, not the source of the supply. This basic fact also means that this type of pricing program is not in violation of the interstate commerce clause. It does not discriminate and distribute benefits by state boundaries. It distributes benefits to the entire milk shed.

There is a drawback in the implementation of these programs due to this fact. If, for example, the state of Connecticut instituted fair share program and states around it did not, retailer payments would go to the processors that supply milk into Connecticut which include Garelick Farms in Franklin, Massachusetts as well as Hood from Massachusetts plants and New York plants. Connecticut retailer payments would be paid out to farmers that supplied milk to those plants. Since most of the milk into those plants did not go to the state of Connecticut, the

amount per farmer would be minimal. As the fair share program is instituted in other states, such as Rhode Island and Massachusetts, then virtually all of the volume of milk from a plant such as the Franklin, Massachusetts plant or the Hood Charleston plant would be covered, and farmers would get a larger undiluted portion of the fair share payment per hundredweight.

4) The legislation needed at the state level to implement this kind of program could be as simple as what the Connecticut legislature passed last year. That legislation authorizes the Milk Regulation Board to make rules and regulations affecting the pricing of milk in the state of Connecticut. Basically state level authorization is needed for a Milk Regulation Board to exist and for it to have the power to regulate retail margins and prices in the milk channel. The Board would also need the power to audit retail operations and possibly the operations of a regional cooperative marketing agency (RCMA) that is established by cooperatives and farmer organizations in the Northeast to oversee the repatriation of these funds to the farmers that produce the milk. Since the cooperatives, most notably Dairy Marketing Services and AgriMark, supply nearly all of the milk to fluid plants they can identify the trail back to individual farmers.

   The state level milk pricing agency would need the power to declare that retailers should pay the amount generated by the fair share pricing rule into a producer settlement fund. They also need for a vehicle to repatriate funds to farmers. We would suggest that a regional cooperative marketing agency (RCMA) be established along the lines of those that were established nearly twenty years ago in the Northeast. This organization would be created by the

agricultural co-ops in the region and other farm associations to oversee and manage the repatriation of funds from the retail stage by the various states to the farmers that produce the milk. A state board may need to request the creation of such an agency, and it would need to work with it to oversee the operation of the producer settlement fund.

5) The policy has the potential to return substantial income to dairy farmers that supply the Northeast fluid market. Attorney Daniel Smith of Montpelier, Vermont has provided a rough estimate. I would note, however, that he has the retailers repatriate virtually all of the money over 20 percent over the 20 percent markup. This 100 percent fair share rate will not work. The proposal that we are advancing from the University of Connecticut would be to establish a fair share rule and repatriate only a portion of the amount over 20 percent. One needs to do this otherwise the retailers have no incentive to raise price, and in that case there would be no money in the fund.

   One might think that a fair share rule, such as 50 percent might well benefit farmers but that retailers would simply raise the price from $3.00 to $3.50 a gallon in order to keep the same dollar margins that they had prior to regulation. This will not happen because it can be prevented by the design of the regulatory fair share pricing rule. For example, the 50 percent rule means that one is doubling the price elasticity of demand that the retailers are actually observing in the market. This is a strong disincentive for further price increases by the retailers. One can also increase the fair share rate progressively to eliminate the retailers' incentive to pass on higher farm prices. Effectively one can manage the

fair share rate to distribute retailer margin to farmers and consumers while preserving a certain amount for the retailer.

6) The greatest benefit or selling point of this proposed policy is its ability to redress the perennial income problem that dairy farmers have in the Northeast. I would note that this approach has minimal budgetary impact on a state's treasury. This is a market based redistribution of income within the milk marketing channel. I would also note that this program fits well with existing federal order and federal dairy policy programs. Moreover, this program would operate successfully even if federal milk market orders were disbanded. Effectively it creates a fluid milk pricing policy that is state based and benefits the milk shed for that state. It is closer to the state marketing orders that we had in New England 60 years ago than it is to the current federal order system.

7) The biggest drawback for this proposed program is perhaps the resistance that retailers will mount to a regulation that reduces their profits. I would, however, note that retailers may very well have a long term benefit from a program like this if it keeps fluid milk production and processing in the region. Absent some new and very strong program to improve the possibility of dairy farming in the Northeast one may observe a reduction in fluid milk supply near existing processing plants and near existing population centers. This means that fluid milk would have to come from more distant areas in the existing Northeast milk market order and quite possibly from outside of the order. This added transportation cost and lengthen supply line would, if anything, detract from the ability of retailers to market fluid milk without price elevation.