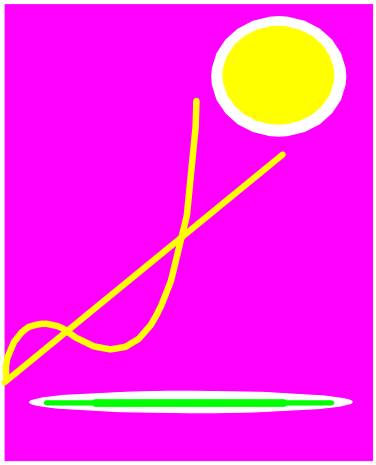

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# Issue Paper

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## Drafting of Connecticut Fair Milk Pricing Law: Further Thoughts on the Retail Price Collar

by

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By
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## Section I. Introduction

In our prior papers, most notably the report dated April 23, 2002 by Cotterill, et. al. We have proposed that the retail price collar be set at 130% and that it be applied only to private label milk. In this briefing paper we will justify the setting of the retail price collar at 130% and suggest that the collar be applied to all brand milk.

## Section II. Why Set the Retail Price Collar at 130% as Opposed to 140%?

In the original proposed law the retail price collar was set at 140%. At that time we had no information on in store cost for retailing milk. Since then we have located research by professor George Criner,the University of Maine, and others from Pennsylvania and New York. Criner reports that the in store cost for retailing milk in four large supermarket chains (two Shaws and two Hannafords Shop N Save stores) are as low as 20 cents per gallon. Research by a Pennsylvania State University economist suggests that in store retailing cost are 32 cents per gallon and the Pennsylvania milk marketing board has adopted 40 cent per gallon cost figure for use when setting their minimum milk prices. The Pennsylvania research, as best as I can tell, is for smaller stores not large chain supermarkets. The New York State Department of Agriculture and Markets has updated the 1984 for Aplin and German study using a 50% adjuster for unknown added costs and a consumer price index adjuster for general price inflation. Their adjusted cost figure is approximately 40 cents per gallon. The Pennsylvania and New York

authorities allow either 2.5% or 3% of the retail price be added to these cost figures as an allocation for net profits on milk. Consequently an upper bound estimate for in store services and a reasonable net rate of return on fluid milk is 50 cents per gallon.

Returning now to our 130% price collar. If one applies that collar to milk at current wholesale prices which are approximately $1.70 gallon, one obtains a retail price of 1.3x1.7= $2.21 gallon and a retail dollar gross margin of 51 cents per gallon. Thus the 130% collar guarantees retailers reasonable profits even at the current, extremely low raw milk prices.

Retailers, however will do even better because we expect processors to increase prices to farmers via over order premiums to maintain their current margins. Consequently wholesale milk prices may well be in the $2.00-$2.20 range. With the 130% markup, retailers' gross margins would range from 60 to 66 cents per gallon. That is considerably lower than the $1.50 per gallon that they capture now, but still very profitable.

**Section III. Application of the 130% Rule to all Brands of Milk at Retail**

In our prior paper dated April 23,2003 we suggested that the 130% retail collar be applied only to private label milk. Our reasoning was that cross price substitutability between brands of milk at retail in a store would effectively force the retailer to reduce branded retail prices. After conversations with milk processors and re-examining the actual margins that we see on branded milk we have changed our opinion. The 130% markup should be applied to all brands of milk for the following reasons. First note the very large brand premiums between Hood milk and private label milk in many New England stores. One can find these brand premiums by referring to our November 19th, 2002 study and our April 23, 2003 study. The later study shows, for example, that Hood milk in many Stop& Shop stores is routinely priced at $3.69 gallon while private label

retails at $2.99 gallon. Upon reflection this is an extremely hefty brand premium. Similar price differentials are also observed for Hood in other leading supermarket chains.

Brand premiums for Garelick milk and Guida branded milk are often as much as $.30 or $.40 per gallon. Dairy Technomics informs us that Guida and Garelick brand milk are priced at the same wholesale price level as private label milk provided by those processors to supermarket chains. Therefore all of the brand premiums on Guida and Garelick branded milk are collected by the supermarket chains. None returns to the processor that has developed the brand.

It turns out that the situation is even more extreme for Hood milk. Hood milk according to Dairy Technomics is sold at wholesale to supermarket chains at approximately $1.70 per gallon. Chains collect as much as $2.00 per gallon more or when they retail Hood at $3.69 gallon. Hood is the company that has innovated and developed the Hood brand, most recently with the move to vitamin C and the light block bottle. Yet Hood collects only an extra nickel or a dime over standard processing costs for its innovation and brand franchise with consumers, and retailers collect as much as $1.50 per gallon in additional net profits above and beyond the .50 that we estimate is necessary to cover in store services and a reasonable competitive rate of return. From a standpoint of economic efficiency concerning new product development and branding this pricing structure is completely out of whack. The company that would innovate and develop new products receives virtually none of the innovative profits that result from the increase in brand loyalty.

Moreover, Hood milk may be experiencing a vertical squeeze play by being effectively priced out of the market by retailers who have contracts with Dean /Garelick for private label and Garelick brand milk. The Dean/ Garelick strategic alliance with Stop & Shop combined with that chain's price leadership in retail markets raises this scenario as a distinct possibility even if it is

not a documented reality. The proposed 130% markup rule will make such games impossible, and thus contribute to confidence that the playing field for processors is level.

Finally we have found that all branded milk i.e. Hood, Garelick, and Garelick milk is often priced at the same price regardless of the amount of butterfat in the milk. For example, Stop and Shop prices all Hood milk (whole, 2%, 1% and skim) at $3.69 gallon. Similarly chains often price Garelick milk at $3.39 gallon across all types and Guida milk is often priced at a similar constant price across all types of milk. This pricing by retail supermarket chains ignores the fact that skim milk is much cheaper than whole because it has no butterfat in it. Raw skim milk currently is as much as 40 cents gallon cheaper than whole milk.

The proposed 130% price collar would force retail chains to pass forward the lower wholesale prices that they pay for skim 1%, and 2% milk. The resulting milk pricing system therefore would be more cost-based and would no longer discriminate against consumers who would buy more healthy, lower butterfat milk in supermarkets.