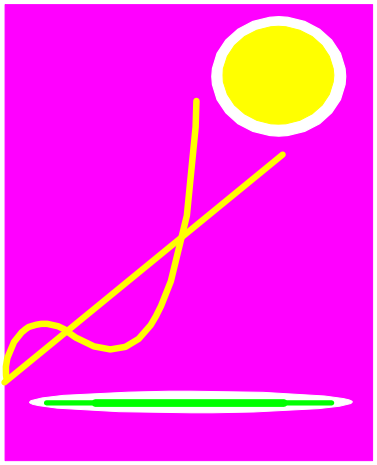

Food Marketing Policy

Issue Paper

No. 40 September 2003

Fluid Milk Market Channel Pricing: Monopolistic Pricing by Retailers Hurts Processors, Farmers, Consumers, and Federal Market Order Pricing

by

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Fluid milk market orders are routinely criticized by many because they force consumers to pay higher fluid milk prices. The Northeast Dairy Compact was also attacked as a cartel that if eliminated would result in lower prices to consumers. The fluid milk processors through their trade group, the International Dairy Food Association, and the supermarket chains, through the Food Marketing Institute, aggressively push this viewpoint in Washington and more recently in the state houses in New England. In fact, what one has is the pot calling the kettle black. Soon after the Dairy Compact's demise raw milk prices plummeted 50 cents per gallon. According to IDFA economists' model, retail prices should have dropped 90 cents per gallon in New England. They dropped only 10 cents. Now raw milk prices have increased 35 cents per gallon, and the IDFA model predicts as much as a 63 cent increase in the retail price. To date prices have increased 10 cents at leading supermarket chains. The crude model that IDEA used to defeat the Compact forecasts so poorly that it is worse than useless.

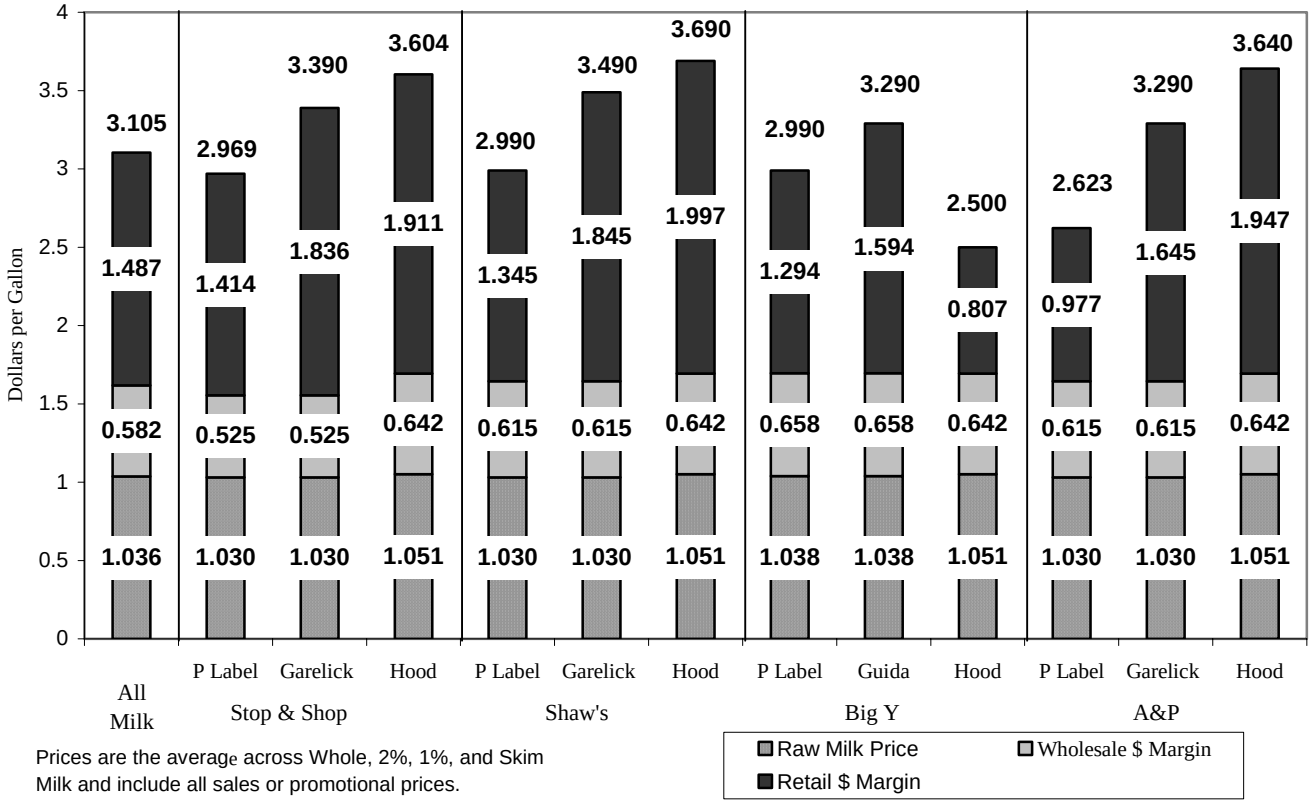
Noncompetitive pricing occurs in milk processing markets and urban grocery markets that have experienced dramatic consolidation. The few remaining larger firms no longer compete on price. Just like a cartel they have power over wholesale and retail milk prices. One needs to make this point central to any analysis of farm to retail price transmission. Consider New England. Dean Foods processes over 70% of the fluid milk.

It has a 20-year strategic alliance (contract) with the region's leading supermarket chain, Stop & Shop, and also supplies private label milk to all but two of the region's supermarket chains. Stop & Shop is the dominant player in many southern New England retail market areas with a market share above 40% and no close competitor. Similarly, Hannaford is dominant in northern New England. In these oligopolies, firms know who their competitors are, and they know that pricing is an independent act. Firms follow each other on price to sustain retail milk prices far above costs because it is the most profitable way to price.

How far above costs? Since last November staff at the University of Connecticut Food Marketing Policy Center have checked retail prices on three separate occasions throughout southern New England. We also obtained wholesale milk prices, i.e., the price that processors charge for delivering bottled fluid milk into the dairy case coolers of supermarket chains, from Dairy Technomics. This firm routinely measures raw milk prices, processing, and delivery costs for supermarket chain buyers who use the information to bargain for lower wholesale milk prices. Even when one accounts for sales and price specials, retail milk prices are far above supply costs.

Here we discuss prices for March 2003; however, this pricing pattern has existed since December 2001. Figure 1 gives prices for the top four supermarket chains that account for 75% of supermarket volume in Connecticut. The top three chains also are the major players in Massachusetts. Processors paid farmers $1.036 per gallon and collected 58.2 cents per gallon for processing and distribution of milk to supermarket chains. The average wholesale price was $1.618 per gallon. The average retail milk price is far higher–$3.10 per gallon. Supermarkets kept $1.487 per gallon, nearly half of the retail

Figure 1: Actual Raw Milk, Estimated Wholesale, and Actual Retail Milk Pricing by Brand for the Four Leading Supermarket Chains in Southern New England: March 2003



Prices are the average across Whole, 2%, 1%, and Skim Milk and include all sales or promotional prices.

price for in store costs and profits. Research at the University of Maine and Penn State University indicate that in store costs for large chain stores is as low as 20 cents per gallon and ranges up to 40 cents per gallon in smaller supermarkets (Pennsylvania Milk Commission, Maine Milk Commission.) We conclude that supermarkets are charging at least a dollar per gallon more than they would be able to charge in a competitive market channel.

Figure 1 also reveals a very extraordinary relationship between retailers and processors. Hood, Garelick, and Guida have developed their branded milk products, but the retailers are capturing virtually all of the brand equity. Examine, for example, Hood milk that is sold at Stop & Shop. Hood charges Stop & Shop $1.69 per gallon at

wholesale and keeps only 64 cents after paying farmers $1.05 per gallon. Stop & Shop adds $1.91 per gallon and retails the Hood milk at $3.60 per gallon. Again, the in-store cost of selling Hood milk is less than 40 cents per gallon. Thus Stop & Shop is capturing a hefty premium, virtually all of Hood's brand equity. The same is true for the other two brands of milk, Garelick and Guida, in Figure 1.

Now let's restate these prices on a per hundredweight basis to focus on the issue of market order price enhancement versus retailer price enhancement. At $3.10 per gallon consumers are paying $35.96 per cwt for fluid milk. Processors are paying farmers $1.036 x 11.6 gal/cwt = $12.01 per cwt for this milk. (Since much of the milk is skim/low fat, this pay price does not include excess cream.) A recent FAPRI study suggests that eliminating the federal market orders would reduce processor pay prices by roughly $1.50 per cwt (Brown). This elimination of "cartel power" pales in comparison to the $1 per gallon x 11.6 gal/cwt = $11.60 per cwt market power premium that supermarkets are extracting from consumers.

Not all areas of the nation have New England style milk channel pricing problems, but many including Seattle and Chicago do (Blake, Zimmermann). Moreover as consolidation in fluid processing and supermarket retailing increase the scenario will become more common. Private economic power and excess milk profits outweigh federal market order price enhancement by a ratio of 10 to 1. Those who think doing away with federal market orders would benefit consumers and farmers in low fluid utilization areas (e.g., upper Midwest) due to lower retail prices and increased fluid milk consumption need to think again. The primary beneficiaries of order deregulation may well be processors and retailers.

Moreover the use of private power in the channel is destroying the economic basis of the orders. Retailers will elevate milk prices until the demand for milk becomes elastic, i.e., the percent decline in milk sold is greater than the percent increase in price. When milk prices are elastic the class 1 price discrimination scheme of the federal orders reduces rather than increases the blend price that farmers receive. At that point private economic power completely destroys the classified pricing system of the federal orders.

What does this rise of private pricing power in the dairy marketing channel suggest for dairy policy? Regional milk pricing policies in areas where this problem exists are in order. Antitrust enforcement that prevents further consolidation is a good idea. But in many regions shutting this door does no good because the horse is already out of the barn. Recently, in Chicago, a consumer class action lawsuit against the dominant supermarket chains, Jewel and Dominick's failed because the price leadership scheme they use is not price fixing. Jewel sets a high price. Dominick's and others match that price. Since no one talks (conspires) with others to set the price, their conduct is legal (Zimmermann).

When antitrust is ineffective, economists look to regulation to improve economic performance. New York has a price gouging law that limits the retail price to no more than 200% of the raw milk price processors pay. Prices, on average, in New York are 83 cents per gallon lower than in New England. New England states are now considering such laws.

Another alternative is a price collar at the processing as well as retail level as was recently proposed in Connecticut. A 140% price collar on the wholesale price provides an incentive for processors to pay higher over-order premiums to farmers. Processors

need 60 cents per gallon to cover their costs. At $1.00 per gallon raw milk price they can charge retailers only $1.40. If they pay farmers an additional 50 cents, then the raw price is $1.50, and they can charge $2.10 and recover the 60 cents. Placing a 130% price collar on retailers means retailers can charge up to 1.3 x 2.10 = $2.73 per gallon. Consumers pay 37 cents per gallon less than $3.10 per gallon, and farmers gain 50 cents per gallon. Given that farm milk prices are severely depressed, this reallocation of income in the channel may be appropriate.

The bottom line is this. It is time for farmers to re-examine fluid milk channel pricing and consider new approaches to dairy policy. Farmers have opportunities to argue for regional milking pricing policies that promote dairy farming in regions such as New England by promoting more efficient as well as more fair milk market channel pricing. Doing so also preserves the effectiveness of classified pricing under the federal orders.

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