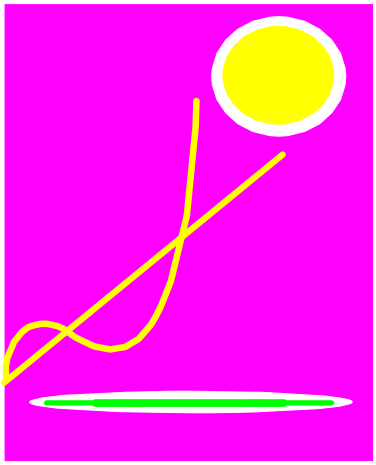

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The Northeast Dairy Policy and Prices Summit Meeting

by

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The Northeast Dairy Policy and Prices Summit Meeting

Post Conference Comments: A Comparison of the Milk Marketing Brand and Price Collar Approach

by

Ronald W. Cotterill*

Our recent meeting provided a factual basis for analysis of alternative milk policies. We analyzed the cost of production on farms, in processing, and in retailing. We collected and analyzed prices at the retail, wholesale, and farm level. This exercise gave us a rare glimpse into the distribution of the price paid by consumers among retailers, processors, and farmers. No one at the conference disputed this factual analysis and the conclusions that the farmer's price is too low in relation to costs, that the retailers net profit margins are excessive, and that consumers, if anything, pay too much for milk in New England. Moreover no one disputed the conclusion that the New York price gouge law contributes to lower retail milk prices when raw milk prices are low. Most conference participants, however, rejected the New York price gouge law as a policy option for New England because they had a strong desire to increase farm prices. The New York law does little for farmers.

The conference, as good as it was, is only a first step in the policy development process. In this paper, I would like to focus on the other two policy options presented at the conference. Now that we have learned about the Pennsylvania milk marketing board approach we can compare it to the price collar approach. But before we do a comparison, and to facilitate a

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meaningful comparison, lets briefly discuss the need and the goal for a regional fluid milk policy.

All participants at the conference clearly maintained that there is a need for a regional dairy policy to elevate raw fluid milk prices. There is no federal alternative that will restore the Northeast's price differential relative to the Midwest, a differential necessary to cover the Northeast's higher cost of production. One might try to revise federal milk market orders but the recent record is not good for the Northeast. The federal milk market orders have been relaxed with the result that the Northeast now often has **LOWER** farm "mailbox" milk prices than the upper Midwest, the nearest supply basin to us, the far west being the more distant supply basin.[1] Several reasons for this surfaced at the conference including:

- the class 1 milk differential (the dollar amount that one adds to the U.S. manufacturing milk price to obtain the federal minimum fluid milk prices) for Boston has remained stuck at $3.25 per cwt for over 20 years. Attempts to increase it by Northeast cooperatives and farm political lobbyists when the Congress has passed farm legislation have failed.
- the pooling provisions of other federal order have been significantly relaxed so that upper Midwest farmers can do paper pooling. This means they can move as little as 10% of a milk supply to a distant order with higher class 1 prices and pool all 100% of that milk supply on that order. This affords upper Midwest farmers (and any other farmers who would pool on a high priced order) a higher raw milk price.

[1] For more on this see my testimony before the Judiciary Committee of the U.S. Senate 10/30/2003 and cited University of Wisconsin research. It is available at www.fmpc.uconn.edu. Click on Milk Price Gouging and scroll down.

- the pooling provisions of the upper Midwest order have been rewritten so that cheese milk can be depooled when cheese prices rise rapidly as they did last summer. This gives Midwest farmers significantly higher farm mailbox prices.
- the buying power of retailers and milk processors in the concentrated markets of the Northeast has limited fluid milk premiums to levels below what one would see in a competitive market channel.

Well, how bad is the situation? Mailbox prices for all of 2002 averaged 11.87 in the Northeast and they averaged $11.89 in Wisconsin. In a competitive market economy the price of milk in the Northeast should be the Wisconsin price plus the cost of transporting milk from that supply basin to the Northeast. The two cent difference is far below the competitive market transport differential.

In August 2003, the most recent month available, and one caught in a vortex of depooling due to rapidly acceleration cheese prices, the Minnesota mailbox price increased to $14.32 per cwt, and the Wisconsin mailbox price was $13.98; but Northeast dairy farmers received only $12.87.

We conclude the following. First milk pricing is political, and is driven among other things by the policy rules embodied in all federal and state milk marketing orders not just the Northeast order. Second since the demise of the Dairy Compact the Northeast has lost price position and is the targeted region for milk supply reduction via the exit of dairy farms. Finally as conference participants agreed, there is a need for a Northeast policy thrust to correct this regional inequity, because federal policy will not address it.

What should the policy's goal be? The conference never explicitly discussed a goals statement. In retrospect we should have. The general consensus at the conference seemed to be

that the Northeast need a policy that preserves the dairy farming operations that are left. No more farmland should be lost to development or reforestation. Based on the on-farm cost of production analyses for 2000-2002 the group felt that the Boston blend price during that period at $13.50 (statistical uniform price which is an average of the announced federal class prices weighted by the amount of milk sold in such class) was too low by about $1.50/cwt. Farmers need $15.00/cwt.[2] In fact they received $15.21 in October 2003.

Now lets examine and compare how a milk marketing board (MMB) or a price collar policy might address this need. Let's examine June 2003, a month where the blend price at Boston was a very low $11.66 per hundredweight. In June the class one price (raw fluid milk at 3.5% butterfat) was only $12.99 and farmers only sold 41.3 percent of their milk as Class I (fluid). The other 58.7 percent was sold in other classes at an average price of $9.98 per cwt. (.413 x 12.99 + .587 x 9.58 = $11.66 the weighted average "blend" price that the pool pays if your farm is in Boston. Hauling handling and other deductions reduce this price and over order premiums increase it to give the farmer's mailbox price).

To increase the blend price to $15.00 per cwt in June 2003 a policy must impose an over-order premium on fluid milk either that equals (15.00 – 11.66)/.413 = $8.09 per cwt.

This means that the announced federal class 1 fluid milk, $12.99 cwt in this example would have to increase to $21.08/cwt. On a per gallon basis the increase is 69 cents up from 1.11 to $1.80 per gallon. This is a hefty increase in milk prices.

Now lets compare the milk board approach to the price collar approach to determine their relative ability to generate over-order premiums in the fluid milk market and to attack this policy goal. The milk marketing board (MMB) approach is as follows: a state such as Connecticut

[2] Note that the farm mailbox price for the Northeast is below the Boston blend price because hauling and handling charges more than offset any premiums that farmers receive. The difference depends on how far a farmer is from Boston with more distant farmers receiving lower prices.

enacts a law that allows the MMB to mandate that processors in the state pay farmers an over-order premium of $8.09 per cwt. If all the New England states independently enact parallel laws it could be a region-wide policy. Since the $8.09/cwt over-order premium increases the processors costs 69 cents a gallon the MMB sets minimum wholesale milk and minimum retail milk prices in the state. These ensure that the processor can recover the 69 cents per gallon over-order premium paid to farmers. Why is this important? Without a wholesale minimum a processor that buys milk from another state that does not have a MMB imposed over-order premium has a huge cost advantage and can undersell the in-state processor who is paying the premium. Similarly a retailer who can buy processed milk from another state that doesn't include the premium can under sell retailers that buy in-state milk if there is no minimum retail price.

Conclusion 1: To make a MMB mandated over-order premium stick one must set corresponding minimum wholesale and retail prices to protect those who pay it from out of state milk that doesn't pay it.

Conclusion 2: Even with minimum wholesale and retail prices there is a huge incentive for processors and/or retailers to go out of the state for milk. Yes the honor the minimum prices but they get to add the over-order premium net of transport costs, to their bottom line. This means that a single New England state, or for that matter all New England states acting in an independent list parallel fashion, would never be able to impose an $8.09 over-order premium in a month such as June 2003 to raise the blend price to $15.00. It would only be able to impose a premium equal to the cost of transporting milk from New York to New England. There is no way a milk marketing board could collect $8.09/cwt or 69 cents per gallon via an over-order premiums.

Consider the current situation in Pennsylvania. The Pennsylvania MMB imposes a $1.65 per cwt over-order premium. This is only 15 cents per hundred weight higher that the current cooperative premiums in the New York City market.

Conclusion: The MMB approach can't do the heavy lifting that is needed to elevate fluid milk prices.

Now lets examine the price collar approach with it 140% price collar on processors and a 130% price collar on retailers. How close does this incentive structure come to the policy goal of $15.00 per cwt blend price?

A 140% price collar wholesale 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 gallon (0.40 x $1.50 = $0.60). Since the June 2003 raw milk price is $1.03 the over-order premium is 47 cents.

A 130% price collar at retail over wholesale price would work as follows: if processors pay over-order premiums to cover costs, they raise wholesale prices to 1.40 x $1.50 = $2.10 per gallon. Then retailers are limited to $2.10 x 1.30 = $2.73. Since the June 2003 retail price averaged $3.07, consumers saved 34 cents per gallon.

Under the price collars the effective Boston fluid raw milk price is $17.50/cwt <u>for the milk that is bottled</u>. Since much of this milk is skim or low fat one also has approximately $2.00 from sale of excess cream. This gives a $19.50 fluid price at Boston and a $13.91 blend price. This is $1.75 per cwt above the 11.66 blend price in June 2003 but $1.09 below the desired $15.00 price.

We will not do the math here but in October 2003 the blend price was $15.21 at Boston and the price collar policy would have added roughly $1.00 to this for a $16.21 blend price at Boston in October 2003.

Conclusion: Although the collar policy as proposed does not attain the target in June 2003 it makes a major contribution and effectively creates a price floor for farmers just like the dairy compacts' price floor. In October it increases the blend price to over $16.00 per cwt. The price collar policy gives farmers a chance of averaging $15.00 over the entire price cycle.

HERE IS THE KEY DIFFERENCE: The key difference between the MMB mandated over order premium and the price collar incentive premium is that a firm operating under the price collar has absolutely no incentive to go "out of state" to avoid the premium. The free rider problem is eliminated. The only way processors can cover their costs when the raw milk price is below $1.50 per gallon is to pay a premium that restores that $1.50 raw price. Going "out of state" does not help them to lower the collar. Wherever the milk comes from the delivered (at the plant) cost must be $1.50/gallon (17.50/cwt) for the milk bottled. Any cream not put in the bottle is sold and also increases the price to the farmer. Please read the other materials on price collars that are on our website including FMPC Issue Papers No. 35, 36, 38, and 40. We will post the draft law as Paper No. 39 next week.