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Fair Pricing Mechanics

by

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Fair Pricing Mechanics

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Fair Pricing Mechanics

General Concept:

Let's look at a 200% price collar, that is the retail price can be no more than twice the raw fluid price paid to farmers. (Mass. Bill)

Assume:

The retail price is \$3.00 and the raw price is \$1.00 per gallon (near today's situation).

To comply, the channel firms can:

1) Cut the retail price to \$2.00.
   Note: This leaves them \$1.00 margin.

2) Raise the farm price to \$1.50 by paying a 50¢ over order premium (O.O.P.)
   Note: This leaves them \$1.50 margin.

Conclusion:

Under this policy processors and retailers will raise raw price by paying over-order premiums.

Fair Pricing Mechanics

Homogeneous Product Case

All processors sell milk as a commodity–No brand premiums.

Now let's look at the Connecticut Bill's 140% price collar for processors.

The market has 3 major processors: Guida, Garelick and Hood. We assume that their processing costs per gallon are:

Hood	60 ¢	(The milk Commission
Guida	55 ¢	will need to measure these.)
Garelick	50 ¢	

We assume RAW PRICE = $1.00

Now in the market place the wholesale price is set by the marginal (the high cost firm) and others capture rents.

$P_{wsale} = \$1.00 + \$\,.60 = \$1.60$

Under the fair pricing bill these processors can charge no more than 140% of the raw price. At $1.60 per gallon they are in violation.

To comply: The marginal processor must raise raw price to $\frac{.60}{.4} = \$1.50$ by paying farmers a 50¢ O.O.P.

Wholesale prices move up to $1.50 + .60 = $2.10 for all firms. Each of the other firms captures $ .60 and continues to do better than the marginal firm. They continue to earn rents.

NOTE: The two lower cost firms will not try to cut the O.O.P. If they did they would earn a lower dollar margin.

Fair Pricing Mechanics

Branded Milk Case

Now the firms sell brands, their costs include cost of branding, and their wholesale prices are different.

Initial Raw Price		Target Margin/.4	Raw Price Needed to Comply	Over Order Premium	Wholesale Price
Hood	\$1.00	$.60/.4$ =	\$1.50	\$ .50	\$2.10
Guida	\$1.00	$.55/.4$ =	\$1.375	\$ .375	\$1.925
Garelick	\$1.00	$.50/.4$ =	\$1.25	\$ .25	\$1.75

1) How do we pay farmers the O.O.P.?

- ❖ Market wide pool (if equal mkt. shares O.O.P. = \$ .375) and need to blend with manufacturing milk??
- ❖ Handler pools: Farmers that sell to a processor get his raw price.

Note 1: If pool breakers go to Hood then co-ops may be able to bargain for and get \$1.50 raw price (50¢ O.O.P.) from the other two.

Note 2: BUT also have manufacturing milk issue.