STATE OF VERMONT

DEPARTMENT OF AGRICULTURE, FOOD & MARKETS

June 5, 2001

Mr. Daniel Smith, Esq.
Executive Director
Northeast Interstate Dairy Compact Commission
Main St.
Montpelier, Vt 05602

Dear Dan,

I read with great interest Ron Cotterill and Andrew Franklin's latest study, "The Public Interest and Private Economic Power: A Case Study of the Northeast Dairy Compact." Cotterill and Franklin take a careful look at the relationship between farm and retail prices for milk in the New England market. They find that it is not a competitive market, as is frequently assumed for economic analysis, because there is little, or frankly no, transmission of price from the farm level to retail. Using a more accurate mean-variance approach to model pricing in a market where input prices are risky, but a few firms are able to control product price, Cotterill and Franklin calculate the amount that the Compact contributed to increased retail milk prices in New England. The amount is far less than the actual increase in retail price. When increases in other unrelated expenses are included, it is clear that retailers and/or processors were able to exercise market power and extract greater profits from the market. Cotterill and Franklin document what is generally accepted as common knowledge - that milk retailers and processors used the Dairy Compact as a mechanism to raise prices to consumers and increase profits.

Cotterill and Franklin calculate the average farm price of fluid milk over the eighteen month period before the Compact at $1.40 per gallon. The average price after Compact implementation for all of New England is $1.51 per gallon. Of that eleven cent increase, four and a half cents is due to the Compact's price floor for Class I milk. Six and a half cents of the increase is due to high market prices for milk that exceeded the Compact floor in ten of the 40 four-week periods studied.

The average retail price for all of New England increased $0.29 per gallon from $2.49 before the compact to $2.78 after Compact implementation. Raw milk costs contribute eleven cents to retail cost increases and non-milk inputs contribute seven cents to the increase in retail price, a total of eighteen cents in increased costs. The remaining eleven cent increase in retail prices represents an increase in the profit margin for retailers and processors beyond the profit margin they enjoyed before the Compact regulation was in effect.

116 STATE STREET
DRAWER 20
MONTPELIER, VT 05620-2901

Considerable market concentration occurred in the fluid milk industry at the processor and retail level during the Compact period. This major change in the structure of the New England dairy industry has a great deal to do with increased retail prices. Price increases due to the Compact regulation were rather modest, as calculated in the study, but industry has pointed to the Compact as the cause for retail price hikes. The Cotterill and Franklin study goes a long way in documenting the magnitude of market power-induced price increases compared to those caused by the Compact.

Milk sold through supermarket channels in the 4 major market areas studied equals 40% of all Class I milk sales in New England. The other sixty percent of Class I sales occurred through supermarkets in the remaining ten percent of New England markets; through convenience stores and gas stations; and through institutional sales, such as hospitals and schools. Cotterill calculates that the Compact cost consumers $19 million in the supermarket channel in these four major markets through higher prices. The remaining $32 million paid to farmers came from dips in the farm price that would not have been matched by dips in the retail price, in other words from windfall profits to retailers and dealers. However, retailers and dealers did not suffer a loss as a result of the Compact. Their response was to raise retail prices even higher to offset any loss of profit and to raise profits even higher using the Compact as a convenient excuse.

An important point raised by the study is that increased retail prices, generated by the exercise of market power, pushed fluid milk prices into a more elastic range of the demand curve. Cotterill and Franklin point out that these higher prices decrease the impact of a price regulation by decreasing demand at the same time that price is raised. Retailers and/or processors raised the retail price to $2.78 per gallon and took the excess profits. If the Compact had generated that same price, allowing for increases in the cost of other inputs, the Compact price floor would have been $18.80 per cwt. with a commensurate impact on farm price.

Cotterill and Franklin examine only the supermarket retail channel. It would be worthwhile to examine price effects in other markets as well, such as convenience stores and institutional purchases. I am certain that further action will be taken in investigating wholesale price increases and market power at the processor versus retailer level.

Sincerely,

Reenie De Geus

Reenie De Geus
Agricultural Research Chief
Vermont Department of Agriculture, Food & Markets