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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:

<table>
<thead>
<tr>
<th>Processor</th>
<th>Cost (¢)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Hood</td>
<td>60</td>
</tr>
<tr>
<td>Guida</td>
<td>55</td>
</tr>
<tr>
<td>Garelick</td>
<td>50</td>
</tr>
</tbody>
</table>

(The milk Commission will need to measure these.)

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.

\[ P_{\text{wsale}} = 1.00 + 0.60 = 1.60 \]

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 \[\frac{0.60}{0.4} = 1.50\] by paying farmers a 50¢ O.O.P.

Wholesale prices move up to $1.50 + 0.60 = $2.10 for all firms. Each of the other firms captures $0.60 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.

<table>
<thead>
<tr>
<th>Initial Raw Price</th>
<th>Target Margin/.4</th>
<th>Raw Price Needed to Comply</th>
<th>Over Order Premium</th>
<th>Wholesale Price</th>
</tr>
</thead>
<tbody>
<tr>
<td>Hood $1.00</td>
<td>.60/.4 =</td>
<td>$1.50</td>
<td>$.50</td>
<td>$2.10</td>
</tr>
<tr>
<td>Guida $1.00</td>
<td>.55/.4 =</td>
<td>$1.375</td>
<td>$.375</td>
<td>$1.925</td>
</tr>
<tr>
<td>Garelick $1.00</td>
<td>.50/.4 =</td>
<td>$1.25</td>
<td>$.25</td>
<td>$1.75</td>
</tr>
</tbody>
</table>

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.