

Part II of DOJ/USDA hearing in Wisconsin

Economist: ‘Cheap food policy is bankrupt’

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MADISON, Wis—Dr. Ron Cotterill did not mince words when it came time for him to address his research on “channel consolidation” during the USDA / Department of Justice (DOJ) hearing here on June 25. Also known as “channel efficiency,” this label describes how marketing channels compress or coalesce (join forces) to streamline “efficiencies” for mutual benefit.

But do these efficiencies ever get passed on to consumers in the way of a cheaper price or passed back to rank-and-file producers in their piece of the retail dollar? Cotterill thinks not. In fact, he says, the opposite is happening in the dairy industry today.

“Our nation’s cheap food policy is bankrupt,” Cotterill declared. “The buyer power (in the middle) is subsidized by the ends (farmers and consumers) as the lion’s share of the margin stays with the retailers and processors. It is cheap food policy for corporate America, that’s all.”

Cotterill is a professor of agriculture and resource economics at the University of Connecticut and director of the Food Marketing Policy Center, and he has been studying the dairy industry for many years. He was one of seven panelists on the topic of “trends in the dairy industry.”

He talked about a “massive shift” in how milk is priced at the supermarket over the past 20 years, and the retailer’s margin on fluid milk has grown from 20% in the 1990s to 40% today. “What was once considered a loss-leader, is today a cash-cow,” said Cotterill, who also took issue with the practice of “flat pricing,” where supermarkets sell all fat contents of milk at the same price.

“Retailers must be put on notice that someone is watching this margin,” said Cotterill.

In evaluating the dairy industry for signs of anti-competitive behavior, he advised the DOJ to “very carefully define these markets.” Some are national, but others, like the fluid milk industry, are regional.

As the “downstream market” has become more “efficient” through consolidation of the marketing channels, the dairy farmer has been “told to get more efficient,” Cotterill observed, adding that dairy farmers are already the most efficient members of the marketing chain. Thus “get more efficient” can no longer be the total answer to the milk-pricing debacle. In fact, he said this leads to the “over-production trap,” where farmers have no other choice but to expand their production because they have very little leverage in the marketplace. Then the over-production takes away what little leverage they have.

While he did not outright blame the cooperatives, he did note they are part of the system that is broken and they participate in this so-called “channel consolidation,” without passing the benefits back to the farmers. He gave the example of a 2003 conference where a former Dairyland CEO said they would no longer “fight,” but instead would move toward “channel efficiency.” After that, Dairy Marketing Services (DMS) was born as a Marketing Agency In Common (MAIC).

The theory is that the bigger, consolidated group of cooperatives is needed to negotiate with the bigger, more consolidated processors.

But, said Cotterill, it doesn’t always work that way.

“The economic theory of ‘countervailing powers’ in this marketplace has been disproved,” he said. “When two large monopolies (retailers and processors / processors and cooperatives) crash heads, they tend to stop fighting and instead coalesce and exploit the two ends: the consumers and producers.”

Cotterill maintained that one way around the problem might be to collect a fee from the retailer and pay it directly to the farmer—totally bypassing the consolidated “channels” in between. He suggested a 30-cent per gallon fee that would equate to \$3/cwt., and even a similar fee on manufactured dairy products.

He described this as one way to go after the farmers’ piece of the “margin” that is stuck in the now-more-efficient and consolidated marketing channel. “Farmers have a natural ally in consumers,” he said, stating his belief that, “Ultimately, fairness in dairy pricing requires a political answer not a marketing answer.”

While panelists danced all day around the Capper-Volstead protection afforded to the milk marketing cooperatives, University of Wisconsin law Professor Peter Carstensen, who also was part of the “industry trends” panel, was perhaps the most direct in this area. He, too, has been studying the dairy industry for many years as a lawyer, not an economist.

He traced the history of some of the mergers and acquisitions that have rapidly consolidated the dairy industry since 2001 and the role of cooperatives in some of the buying and selling of plant capacity as well as securing full-supply contracts that serve as quasi gatekeepers to supply and demand.

“What is it that the co-op managers are up to, that, but for their Capper-Volstead protection, would be felonies?” Carstensen asked. “If they are keeping to the principles of cooperative marketing, they have nothing to worry about. No one here is trying to eliminate the Capper-Volstead protection, but questions are a fair thing to ask. Cooperatives should have to open their books like any other public company.”

For sure, the Capper-Volstead Act was not on trial during the dairy-focused USDA / DOJ hearing. That was made clear at the outset by U.S. Secretary of Agriculture Tom Vilsack, Assistant Attorney General Christine Varney, and both Senators Herb Kohl and Russ Feingold in the morning roundtable and producer panel discussions.

And there was plenty of support for cooperatives throughout the day, particularly during the two hours set aside for public comments, when a steady stream of cooperative members came to the microphone with a similar template. First they each—one by one—told how many choices they have for selling their milk in their respective regions and then they each—one by one—told why they chose their cooperative, mainly, said most, to market their milk so they can concentrate on running their farms. They also mentioned membership benefits like health care. They talked about how they, as producers, “invest” in their coops, which in turn “invest” in them.

The majority of these comments were made by DFA members who traveled to Wisconsin from various states, including Pennsylvania, and a few comments were made by members of other cooperatives, like Land O’Lakes and St. Albans.

Among the producers placed strategically on the three expert witness panels, the story continued much the same. The terms “effectiveness” and “efficiency” were used throughout the day—often with differing meanings.

In fact, Jerrel Heatwole—a dairy producer with 60 cows in the state of Delaware—sat at the table with some of the law and economics professors on the “industry trends” panel. As a member of DFA, he was defiant as he challenged the conclusions of academia. “As a dairy farmer, my life, my income, depends on the choices that are made,” he said. “A professor’s choices don’t impact his income or his tenure, but it can impact me as a dairy farmer.”

Heatwole said he represents the Lancaster County, Pennsylvania area with DFA, and in that area he can find 16 people to pick up his milk—six cooperatives and eight to 10 proprietary companies. He said there are “lots of choices,” and he maintained that in the top six dairy states (California, Wisconsin, New York, Idaho, Pennsylvania and Minnesota), DFA’s milk market share runs from 6% to 14%. This, he compared to major retailers and processors with a high percentage of market share “in market after market after market.”

“Who do you think has the power?” he asked. He also pointed out that some other countries have only one cooperative for the whole country. And he said that it doesn’t really

matter what the cooperative market structure is because “the members find value in it or else they wouldn’t stay.”

Ron Kappelman, chairman of the board for Land O’Lakes, talked about how it’s important for co-ops to be “effective” and “relevant.” He said Walmart is 100 times larger than the largest dairy cooperative; Kroger is 20 times larger.

“We do not feel ‘big’ in this environment,” he said. “My question is: ‘Who is big and what is big enough?’” His point was that cooperatives get bigger and more consolidated to try to give producers some leverage in a marketplace that is increasingly dictated by big and bigger.

Yet, at the end of the day—whether speakers were defending today’s milk cooperatives, or questioning them, or remaining completely neutral—the prevailing question among rank-and-file dairy farmers came back to: “How’s it working for us?”

What seemed clear is that the current system is lacking in its effectiveness at the farm level, since every dairy producer who spoke—either at the open-microphone or by invitation on one of the panels—stated their primary concern is for the next generation on the farm as the dairy producers’ share of the retail dollar has fallen from around 50% in the 1990s to 38% in 2004 to 27% in 2009.

They talked about how they run their farms and gave examples of technology and the quest to “get more efficient.” Yet these words rang a bit hollow as the three panels of experts dissected the dairy farmers’ extreme loss of leverage in the marketplace.

Several experts (as noted above) examined this idea of “efficiency” and how it has transformed milk marketing to the point where the current pricing system has lost its effectiveness.

Bob Cropp, retired emeritus professor of ag economics at the University of Wisconsin, noted that cooperatives are small businesses when compared to their customers. Of the current 155 co-ops in the U.S., only about 25 are processing co-ops and they may produce 71% of the butter and 60% of the powder, but when it comes to natural cheese, the share slides down to about 26%. In fact, he said that the top four co-ops account for a little over six billion pounds of milk and the top 10 co-ops together have 57% of the market share, with DFA having about 20% of the market and Land O’Lakes about 7%.

“The cooperatives are, by themselves, small in terms of market power,” he said. “But through Marketing Agencies In Common (MAICs), they negotiated over-order premiums last year averaging about \$2.25 per hundredweight.”

He also talked about how cows are milked every day, producing milk every day, but the demand is somewhat seasonal. This puts the job of coordinating the milk for its various uses at the feet of the cooperatives, which end up balancing regional milk supplies for all shippers in a market—members and independents alike.

“That is a market-wide service they (co-ops) provide to the whole marketing system,” Cropp explained. “So some of this over-order premium money goes to the cooperatives for providing that market-wide service to balance the market and move the milk around to wherever it’s needed.”

Cropp contends that this results in a mailbox price to farmers, which is higher than the Federal Order minimums in most—but not all—milk-marketing areas.

Where a lot of the criticism comes into play is in fluid milk market because of full supply contracts with bottlers, he admitted. But he said the problem today is that 97% of the milk produced in the U.S. is Grade-A, and the original purpose of the Federal Orders was to ensure enough Grade-A milk to drink.

“Now there is more Grade-A milk available than is needed, so more milk participates (is pooled) in the Federal Orders for some of that higher (Class I) price,” Cropp explained. “This suggests that there is really more of an issue to address with the Federal Orders.”

Part III next week will focus on transparency and consolidation in the marketplace.