

Discovering Price

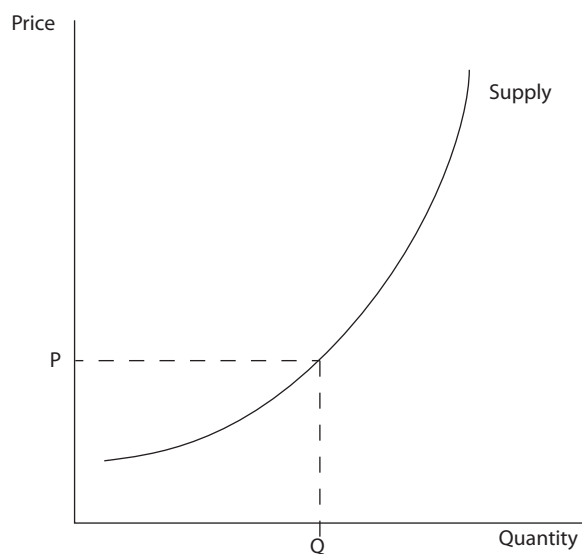
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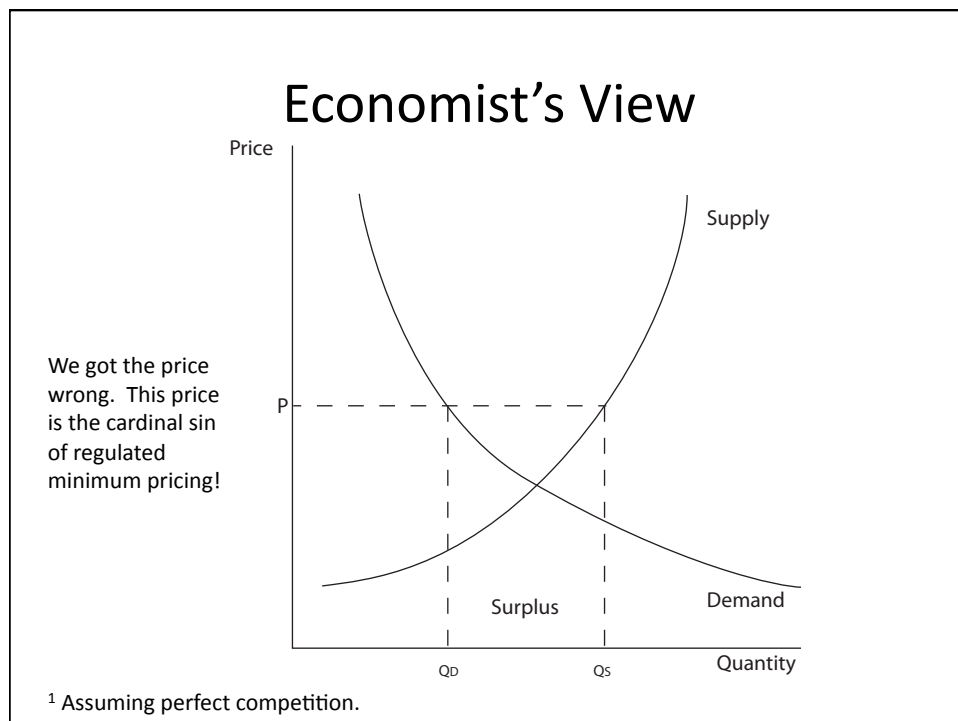
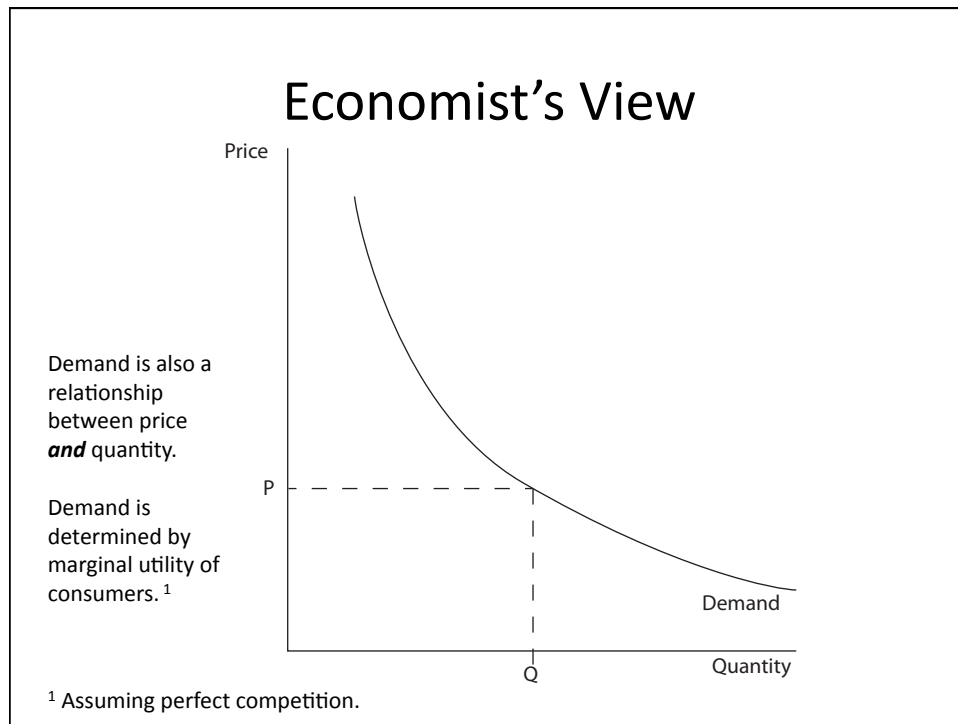
Economist's View

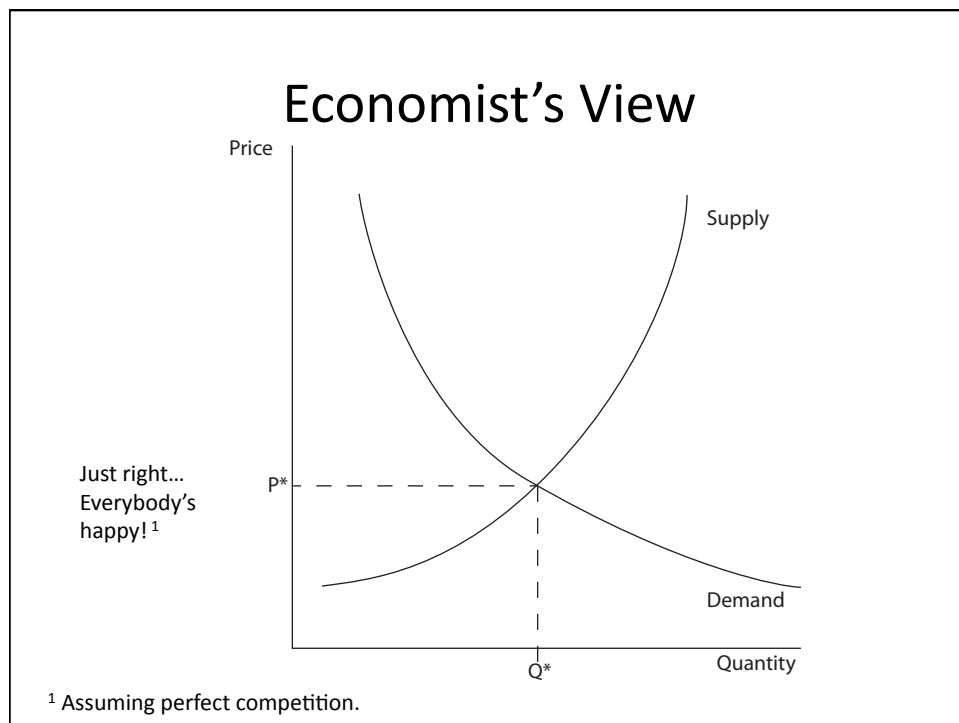
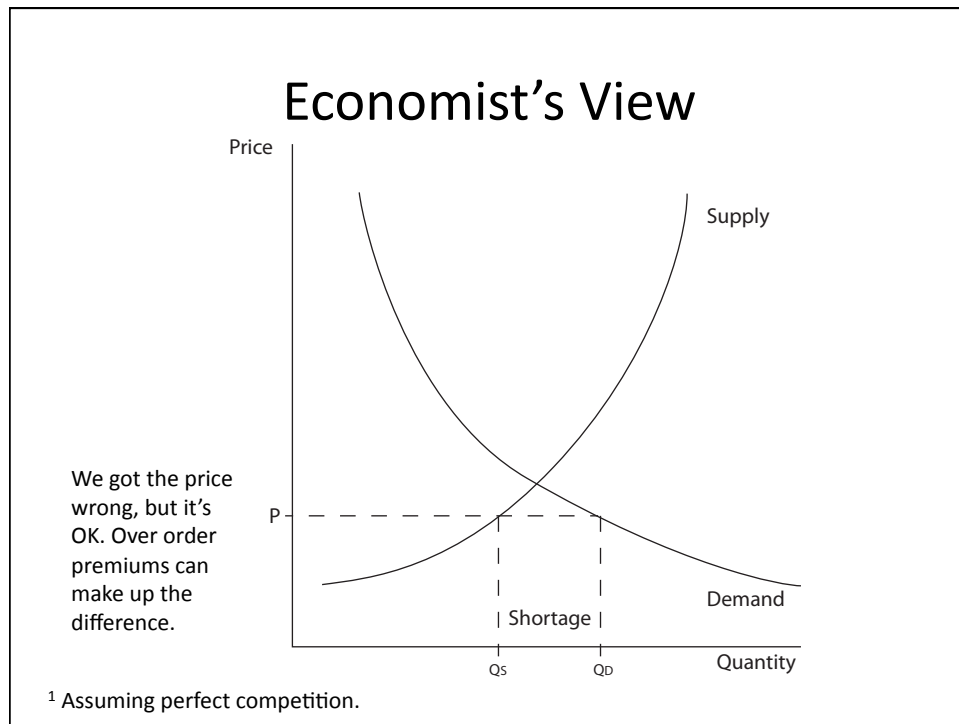
Supply is a relationship between price **and** quantity.

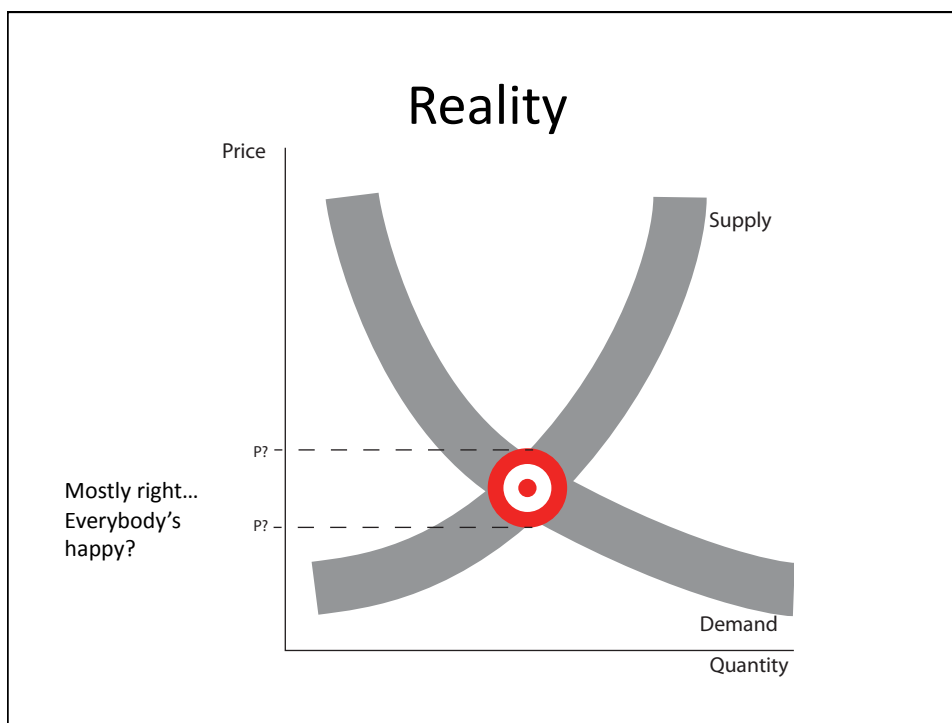
Supply is determined by marginal cost of the firms.¹



¹ Assuming perfect competition.







How Does Price Get Discovered?

- How do we assess the marginal cost of firms and the marginal utility of consumers?
Moreover,
 - How do we do it monthly
 - And transparently
- How does anyone do it?
 - The invisible hand...

Different Mechanisms

- Individual Negotiations
 - No formal market needed
 - Range of prices, but approximates the competitive outcome if accurate economic information is readily available.
- Organized Exchanges or Auctions
 - Spot or cash markets where actual commodities are traded
 - Futures markets where actual commodities may be traded
 - Auctions work when commodities are difficult to standardize
 - An advantage of Exchanges or Auctions is that they provide an impersonal method of pricing.
 - Outcome approximates the competitive outcome if
 - Volume of transactions is large
 - Quality of product sold is representative of total production
 - Sufficiently large number of both buyers and sellers
 - Unbiased and accurate economic information
 - Can have excessive price fluctuations

Different Mechanisms

- Formula Pricing
 - Impersonal, prompt, low-cost method
 - Competitors face the same price
 - Often uses a base price survey or exchange report combined with various indices
 - Think of CME \pm pricing or cream multiples
 - Think of the BFP
 - Think of our current product price formulas
 - Drawback is often base price problem
 - As formula is used on more product, there is less base to survey (Think of the M-W)

Different Mechanisms

- Group Bargaining
 - Cooperatives perform this function now
 - Less volatile price changes
 - Congressional bills have been drafted to compel negotiations (like labor unions)
 - **Marketing Agreements**
 - Only successful in the long-run if they can control the large majority of the product and can control supply.
 - Generally work best in products with more inelastic retail demand (can pass higher prices along without substantial loss of sales)
 - Currently challenged by Dept of Justice and threats to Capper Volstead

Different Mechanisms

- Administrative Decisions
 - Almost exclusively a government function
 - Think of regulated electric or other public services
 - Often very elastic demand for product
 - Think of price-support loan rates for grains
 - Think of price-support program for dairy products
 - Almost always need to be able to regulate supply

Really Only a Few Choices

- If we retain FMMO regulation...
 - Formula pricing
 - Organized Exchange or Auction
- If we abandon regulation...
 - Group Bargaining
and / or
 - Individual Negotiation
 - Could just pool differentials

Why Regulate Anyway?

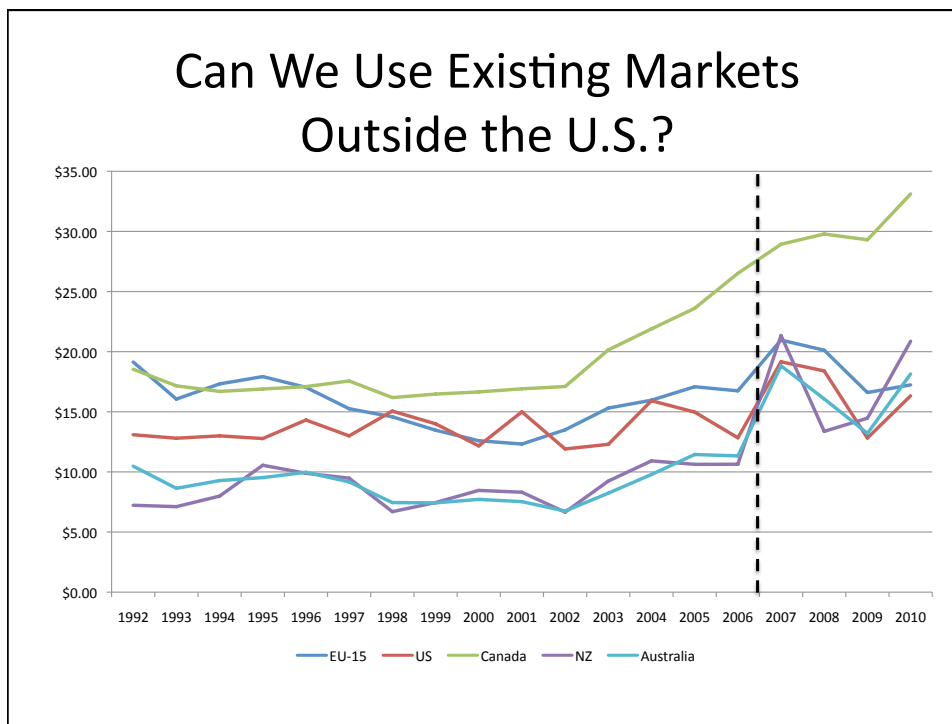
- Milk has unique properties
 - Highly perishable
 - Bulky
 - Many more sellers than buyers
 - Single purpose assets
 - Quite inelastic supply and demand
- Historically:
 - Destructive competition
 - Coops couldn't quite do it on their own
- Are these factors still in play?

With Formula Pricing...

- Is there another bunny to pull out of the hat?
- What would the base pricing be?
 - Products
 - Competitive sample
 - Organized Exchange or Auction
- What other indices might be used?
 - Cost of production or processing
 - Retail prices

With Organized Exchange or Auction...

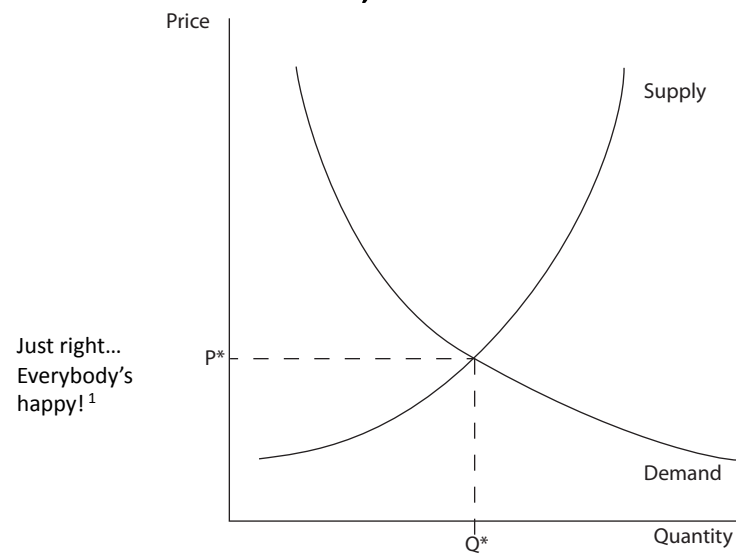
- They are a major information sponge and react quickly to new details
- Organized Exchange does converge to market price
- What happens to cash settled markets without neutral 3rd party announcement
- Would need to encourage market participants to use risk management tools



In My Opinion...

- We aren't ready to lose regulated pricing
- But today's dairy industry is increasing complex and harder to regulate.
- I'm intrigued with Organized Exchange or Auction pricing
 - Could be combined with indices in formula price
- If we were ready to lose regulated pricing, then Marketing Agreements and/or pooling differentials could be an intermediate step.

Remember, This is the Goal



¹ Assuming perfect competition.