

Foundation for the Future Federal Order Reform Program

Executive Summary

Through a number of meetings over the past twelve months the NMPF Strategic Planning Federal Order Reform Subcommittee has developed a proposal that that will be part of the Foundation for the Future. It addresses basic issues associated with the current milk pricing system of concern to both dairy producers and processors. The proposal:

- Replaces end product pricing formulas with a competitive milk pricing system.
- Incorporates two classes of milk – fluid (Class I) and manufacturing (formerly Class II, III and IV product uses).
- Maintains the *higher of* for establishing the fluid use (Class I) minimum base price.
- Maintains current Class I differentials
- Maintains the number and basic structure and provisions of federal orders

The proposed reform program is focused on basic pricing and changes in pooling that follow from the price changes, as well as recommending consideration of additional and reformed balancing programs. The basic framework of the federal milk marketing orders – including marketing areas, Class I differentials, producer location differentials and plant and producer pooling qualifications – are left intact. That is, it does not propose to start from scratch on the myriad Federal order details that have been designed to serve many specific and regional needs.

Introduction

The Federal Milk Marketing Order system provides substantial benefits to producers. These include the equitable pooling of minimum Class I revenues, important market information, and the third-party audit of milk use in plants.

Unfortunately, the current end product pricing formulas used to calculate minimum manufacturing milk prices have had some unintended consequences since they replaced competitive milk price surveys in 2000. The make allowances and yield factors built into these formulas have become a source of conflict in the industry and have created winners and losers. Producers believe that make allowances unfairly guarantee a profit to processors and processors insist that the formulas don't allow them to capture a fair return on their investment. There is also concern that the make allowances negatively impact the Dairy Product Price Support Program and put federal order processors at a competitive disadvantage with unregulated areas and state milk marketing orders.

In addition, the inflexibility of minimum prices based on specific product prices can create risk for processors who produce other products, when the government requires them to pay a price that doesn't match the value of their products.

There is also concern by both producers and processors that the Federal orders don't adequately address the difficulty and expense of balancing fluid milk supplies.

The primary objectives of the Foundation for the Future (FFTF) Federal order reform proposal, then, are to 1) address the inequities and the inadequacies of end-product price formulas; 2) encourage manufacturers to produce new products resulting in higher returns both to themselves and dairy producers; and 3) more equitably reward producers and handlers for balancing milk supplies.

The resulting proposal focuses on adopting competitive pricing for manufacturing milk, while maintaining minimum price protection for fluid milk, and pursuing new balancing programs in markets where needed. Many other elements of the Federal orders, developed over the years for many specific reasons, are left as they are, including Class I differentials, marketing areas, pool plant definitions, and producer pooling qualifications.

The proposed reform program is more market-oriented while preserving the most valuable elements of Federal orders. The use of a competitive pay price will enhance price discovery and facilitate the ability to export offering greater opportunities for U.S. dairy products in the global marketplace.

Two Classes

This Federal Order reform proposal will improve price discovery and the transparency of milk pricing. The key element of the proposal is the elimination of the end-product price formulas for manufacturing milk, including make allowances. All milk used in manufactured dairy products will be competitively priced. Consequently there will be no minimum prices manufacturers are required to pay for milk used to produce these products.

There will, in effect, be two classes of milk use:

- **Fluid milk products.** Milk used to produce fluid milk (Class I) products will be subject to minimum pricing, plus market-based premiums.
- **Manufactured products.** Milk used for manufacturing (under the current system Class II, III and IV products) will be competitively priced in the market.

Fluid milk (Class I) Price

Each month, USDA's Agricultural Marketing Service will carry out a survey of the competitive price paid by proprietary cheese plants to cooperatives and individual producers for milk used to make cheese. Proprietary plants (including those with 50% cooperative ownership or less and managed by the proprietary partner) producing all types of cheese will be surveyed if they process a daily average of at least 250,000

pounds of milk and are not subject to minimum pricing for that milk (under a state order, for instance).

The data collected by USDA in the survey will include pounds of milk and pounds of butterfat, all premiums, component values, hauling subsidies, lab and field service costs where applicable. Forward contracted milk would not be included.

USDA will publish the results of this survey for each of 5 regions. These regions would correspond to, and expand upon, the current Federal order markets, but are defined for reporting purposes only. There will be fewer reporting regions than Federal order markets to insure that each region has a sufficient volume of manufacturing milk use to result in a robust competitive pay price. California would be excluded from the survey so long as it continues to set a minimum price for cheese milk.

The national fluid milk (Class I) price mover will be the *higher of the* national weighted average competitive cheese milk price survey, or the current Class IV formula butter-powder milk value. It will be announced in advance. For example, the Class I mover for April would be the higher of 1) February's national average cheese milk competitive price, adjusted with weighted average NASS block and barrel cheese prices for the first two weeks of March, or 2) an advanced Class IV price as currently calculated. The April Class I price mover would be announced by the 23rd of March. A handlers' minimum price for Class I milk would be this national mover plus the current Class I differential at the plant.

The minimum price bottling plants would be required to pay to the producers and cooperatives supplying Class I milk would be equal to the lowest regional competitive cheese milk price plus applicable producer location differentials, lagged and adjusted the same way as the Class I mover (above). Bottling plants would be expected to pay a competitive market price for the rest of their milk utilization.

The difference between the Class I price and the minimum price to producers would be paid into the pool, as outlined below.

Manufacturing Milk Price

The price producers are paid for milk in manufactured dairy product uses (as currently defined for Class II, III and IV) will be a competitive price. There will be no minimum price for manufacturing milk.

Each region's competitive price for milk used to produce cheese, in addition to being used in establishing the Class I base price, as described above, will be used to determine the butter-powder plant pool credit and the lowest of the regional competitive cheese milk prices will enter into the calculation of the Class I pool contribution. (See Pooling below.)

Pooling

In order to stabilize pooled values and eliminate most plant de-pooling, the Federal order pool would be a modified pooling of differentials, resulting in a producer price differential. That is, instead of pooling four class prices, relatively stable price differentials and balancing credits would be paid into and out of a differential pool, as follows:

- Handlers of Class I milk would contribute to the pool the lagged difference between their Class I price and the lowest regional competitive price. Both the Class I price and the lowest regional competitive price would be announced in advance and lagged in the same way. The Class I pool contribution would be consistently positive from month to month, because it would not depend on a pooling of old and new prices, but would only depend on the fixed Class I differential and a consistently positive difference between the national mover and the lowest regional cheese milk price. In fact, the full contribution to the pool per cwt. of Class I milk would be known by the 23rd of the month before.
- Handlers of a subclass of perishable manufacturing milk (generally products now in Class II) would contribute a fixed differential of 30¢ per hundredweight in the pool.
- Handlers of milk used to make cheese would have no contribution or draw.
- Handlers of milk used to produce butter and milk powders would receive a payment from the pool when the national value of milk used to make powder and butter as calculated using the current Class IV formula adjusted for energy costs is less than the regional competitive cheese milk price. When the Class IV formula is higher than the regional competitive cheese price, the Class IV handler shall pay the difference into the pool. The payment to those who manufacture butter and milk powders will not exceed the funds available in the pool. The blended result after the distribution would be a producer price differential for all pooled producer milk that would be paid directly from the Market Administrator to producers and producer cooperatives.

Balancing and Transportation Credits Addendum

USDA will be required to hold hearings, either at the national or orders, when requested for the purpose of considering and implementing proposals to compensate handlers that truly perform balancing services for the Class I market. These hearings are to include but not be limited to:

- ***A plant balancing credit*** to manufacturing plants that provide balancing services to the market.
- ***Intramarket transportation credits*** for markets in which balancing is based on long shipments of milk from within the marketing area.

In Summary

The Foundation for the Future proposal to revise Federal Milk Marketing Orders will provide a number benefits:

- Discover a true market price for milk used in manufactured products rather than a price generated by a formula using thinly-traded product values and contentious make allowances;
- Reduce price volatility. Analysis shows that a competitive pricing system results in less volatility than product price-driven formulas;
- Encourage product innovation by not locking manufacturers into a minimum price based on the value of a dissimilar product.
- Provide more equitable compensation to the cooperatives and other handlers who do the hard work of balancing fluid markets.
- Maintain the core framework of Federal milk marketing orders

Federal orders provide an important support system for processors, dairy farmers and cooperatives through pooling of Class I values, providing third-party audits to verify market pricing, and helping to maintain supplies for fluid processors by compensating their suppliers. Without reform, Federal orders will be strained to the point that their existence comes into question, to the producer's loss.

The reforms proposed as part of Foundation for the Future will accommodate the growing complexity of U.S. and international dairy markets while maintaining the basic framework of the FMMO system and preserving the elements of the orders that are most important to producers and processors. These reforms will promote a milk pricing system that compensates producers fairly, reduces price volatility, and creates a more dynamic dairy industry.