



Information Letter Series

Interpreting Proposed Language for the California Federal Milk Marketing Order

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Date

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Highlights:

- The California FMMO proposal addresses milk depooling by modifying the pool plant provisions. This is done by classifying all plants, fluid and non-fluid, in the defined marketing area receiving milk from dairy farmers in the marketing area as “pool plants.” Regulated handlers are not permitted to depool producer milk received at a pool plant.
- Premium payments based on the state quota program will be administered by USDA and could be provided minimum payment enforcement and auditing benefits. CDFA will report the quota value to USDA and will continue to monitor quota transfers and the sales price.
- The proposed California order functions similar to a multiple component pricing order. First the classified value of milk in all four classes minus the fortification allowances is totaled. Then, after deducting the value of quota and transportation credits the remaining monies in the pool will be used to determine the regulated minimum price.
- The California FMMO will not have a conventional producer price differential. In lieu of a per hundredweight announced producer price differential, California uniform butterfat, protein, and other-solids component values will be adjusted up or down based on their contribution to the Class III value and the residual value of the marketwide pool.
- By default, and under the provisions of the Dairy Forward Pricing Program, California handlers regulated under FMMOs may manage risk using forward price agreements. Milk in non-fluid classes under forward contract would not be subject to FMMO minimum price provisions.

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On February 5, 2015, USDA received a formal hearing request to establish a Federal Milk Marketing Order (FMMO) for the State of California ([Proposal for a Federal Milk Marketing Order for California](#)).³ The proposal requests for the entire state of California to abandon the existing state system and join the FMMO program, and includes provisions for pool quota premiums, mandatory pooling, transportation credits, and fortification allowances.

One of the stated goals of the California proposal is to align regulated minimum milk prices in the state with those announced and enforced by USDA FMMOs. With that in mind, classified prices and end-product pricing formulas in the proposed California FMMO are consistent with the FMMO system. Additionally, market service functions such as the verification of producer weights and tests and auditing provisions will be provided for as is presently done in the FMMO system. The primary difference between the proposed California FMMO and marketing orders across the U.S. - and the methods by which the aforementioned provisions are implemented - arises in the pool qualification criteria, the computation of handler obligations, and in the determination of regulated minimum uniform price(s).

This Information Letter presents an interpretation of the major provisions of the proposed California order alongside comparable provisions found under FMMOs. Topics covered include: pool plant and producer milk provisions, accommodation of quota premiums, transportation subsidies, statistical uniform price(s), and finally forward contracting provisions. These interpretations should not be considered authoritative and final rules for a California FMMO would be subject to a USDA hearing process and could be substantially different than those proposed.

Pool Plant and Producer Milk Provisions⁴

Participation in the FMMO revenue pooling process is voluntary for milk in manufacturing classes. During the monthly pooling process and after the classified prices have been announced, producer milk in non-fluid classes may opt-out of the pool, thereby foregoing FMMO minimum price provisions. Depooling is advantageous when the classified value of milk exceeds the anticipated uniform price and allows for the revenue from higher valued milk sales to remain outside the pool. When depooling high valued milk the revenue from milk sales is not fully shared among producers servicing the marketing area.

One of the methods by which the proposed California FMMO addresses voluntary depooling is through modifying the pool plant provisions. This is done by classifying all plants, fluid and non-fluid, in the marketing area receiving milk from dairy farmers in the marketing area as “pool plants.” Furthermore, any plant located in Churchill County, Nevada receiving milk from producers in Churchill County or the state of California is classified as a pool plant. By “locking-in” both fluid and non-fluid plants as pool plants, these plants are fully regulated and producer milk received at these plants may not be depooled.

Locking-in plants to a specific order is not without precedence. In general, FMMOs regulate distributing plants based on the location of their sales, not on the physical location. However, situations exist where plants have a larger distributional footprint of fluid milk sales or have a unique

³ For details on FMMO functions see www.ams.usda.gov/dairy and <http://www.ams.usda.gov/AMSV1.0/FederalMilkMarketingOrders>

⁴ See § 1050.7 and § 1050.13 of the proposed California FMMO. For other order provisions see § _____.7 and § _____.13.

method of milk receipts. In these cases FMMOs may “lock” these plants into a particular marketing area in an effort to protect the integrity of the pool (e.g. Mideast and Arizona orders). Other “lock-in” provisions can be found in the Appalachian, Florida, Southeast, and Southwest orders where plants, and cooperative-owned plants, located in or nearby to a marketing area can voluntarily request pool status if qualification criteria is met.

However, “lock-in” provisions may not prevent exit and reentry into the California pool. Not including Churchill County, plants outside the California marketing area may voluntarily pool milk on the California order by meeting the qualification requirements set forth in the order. To make exit and reentry of producer milk more gradual, the proposed California order has provisions which limit the amount of producer milk (from both inside and outside the order) to no more than 115% of the prior month’s pooled milk.⁵ This is not uncommon, as many FMMOs limit the amount of producer milk eligible to participate in the pool. For example, percentages vary, but the Central, Mideast, Northeast, and Upper Midwest all limit the amount of producer milk eligible to participate in the pool to a percentage of the prior months pooled milk volume.

Quota Premium Values⁶

One the most important issues of a California FMMO is the ability to accommodate a quota. The 2014 Farm Bill specifically permits California producers to keep some form of their unique quota system if a Federal Milk Marketing Order is adopted. The quota is an asset, and provides a separate source of revenue for dairy producers in California. Producers in the state are paid on the basis of their allocated quota, base, and over-base production at prices which generally reflect the utilization of milk in the California market. Approximately 60% of California dairy farmers own quota. Estimates based on recent California Department of Agriculture (CDFA) data indicate there are 2.2 million pounds of solids-non-fat quota with a state-wide value in excess of \$1 billion dollars.

Under the California FMMO proposal, each month CDFA will report the quota value to the California FMMO. It is anticipated that CDFA will continue to monitor quota transfers and the sales price. However, CDFA will not collect or distribute quota monies. Instead, USDA will first publically announce the quota premiums, and then will be tasked with distributing quota premiums from the marketwide pool to producers holding quota. While CDFA will monitor quota value, through these provisions, it is possible that the state-administered quota program could become a market service benefit that will be administered by USDA and subject to payment enforcement and auditing provisions.

Transportation Subsidies and Assembly Credits⁷

Across the U.S. each county is assigned a fixed Class I location differential. The Class I differential reflects higher marketing and transportation costs of servicing the fluid market in a particular location. For example, Class I differentials in California range from a low of \$1.60 per hundredweight in central portions of the State to a high of \$2.10 per hundredweight in the Southern California (Los Angeles) region. However, Class I differentials may not fully cover the costs of transporting milk into deficit milk production regions.

⁵ This percentage can be waived by the Market Administrator.

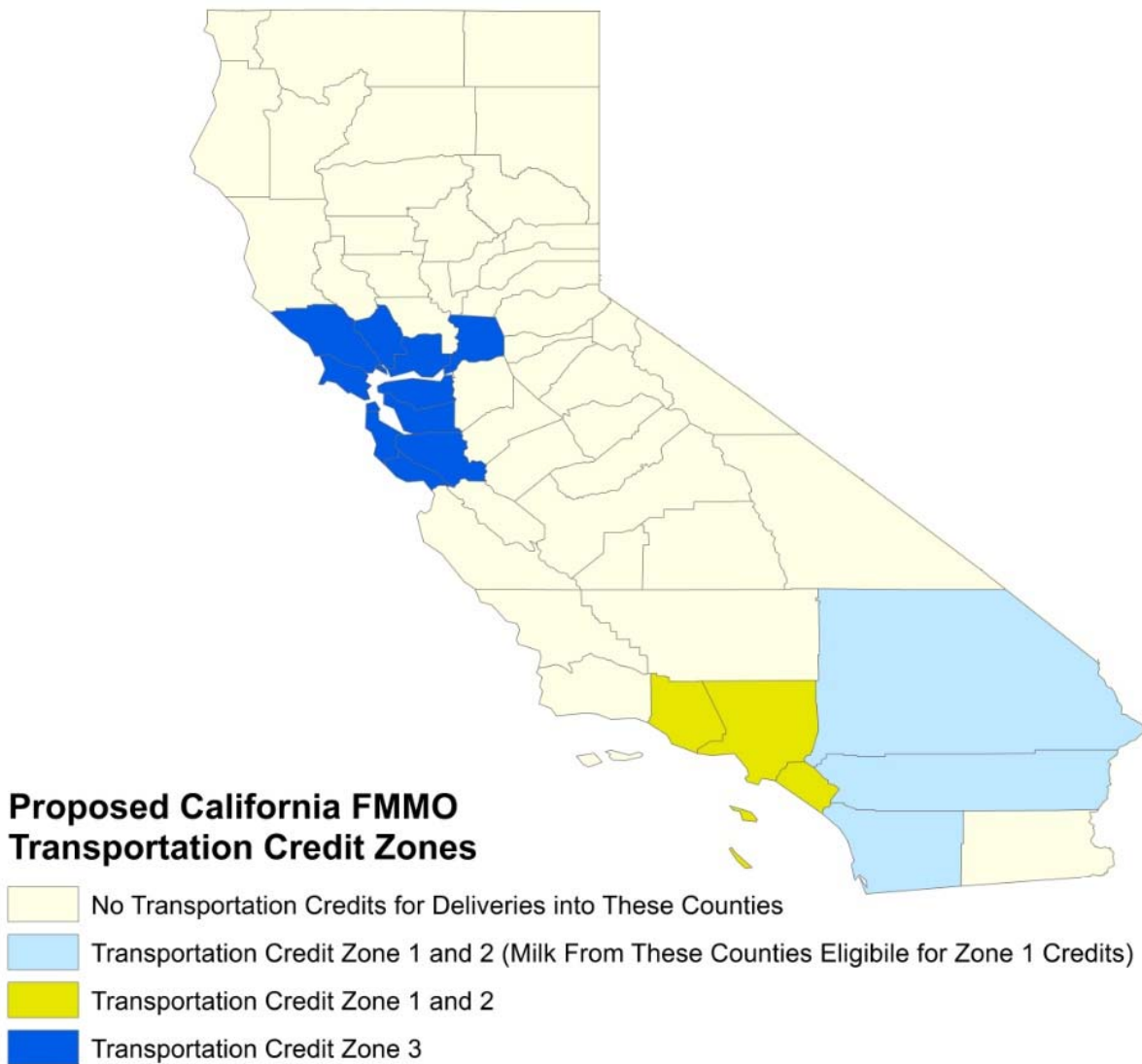
⁶ See § 1050.61, § 1050.62, § 1050.71, § 1050.72, and § 1050.73.

⁷ See § 1050.55, § 1050.56, § 1030.55, § 1005.80, § 1005.81, § 1005.82, § 1005.83, § 1007.80, § 1007.81, § 1007.82, and § 1007.83.

⁸ Formulas for FMMO transportation credits can be found in the appendix.

To address this issue the California proposal includes transportation subsidies for the movement of milk into Class I and II processing locations, Figure 1. Transportation credits are based on three geographic zones and provide financial assistance in moving milk into the Southern California and Bay Areas (i.e. Los Angeles, San Diego, San Francisco, etc.). The California transportation subsidy will vary month to month and will be a function of a mileage rate determined using weekly diesel prices reported by the Energy Information Administration (transportation credit formulas may be found in the appendix). The transportation subsidies will be considered a marketwide service payment and will be deducted from the marketwide pool before uniform milk prices are determined. Transportation subsidies will not be adjusted to reflect Class I differentials.

Figure 1. Proposed California Transportation Credit Zones



The Appalachian, Southeast, and Upper Midwest FMMO marketing areas administer transportation and/or assembly credit provisions. In the Upper Midwest assembly credits do not include fuel prices

and are estimated based on the volume of milk shipped and the delivery miles. The assembly credit is then adjusted on the difference, if positive, in Class I location differentials. In the Upper Midwest these credits are considered a marketwide service payment and are deducted from the pool prior to the determination of uniform prices.

In the Appalachian and Southeast marketing areas transportation credits are not considered a marketwide service payment and are not deducted from the pool. Instead, in these orders transportation credits are maintained through a separate transportation credit balancing fund. Funds are accumulated into the transportation credit balancing fund through assessments on Class I producer milk receipts (\$0.15 per hundredweight in Appalachian and \$0.30 per hundredweight in the Southeast). Then, during seasonally-deficit milk production months handlers may request transportation credit payments from the fund to offset the additional costs of securing long distance loads of supplemental milk. The transportation credits in these orders are adjusted based on the difference, if positive, in Class I location differentials, and similar to California, adjust transportation credits using a mileage rate factor.

The California FMMO proposal for transportation credits represents a hybrid-plus approach. The additional feature in California transportation credits not found in other FMMOs is the use of multiple transportation credit zones within an order, Figure 1. Common features include mileage factors and categorization as marketwide service payments. Similar to the Upper Midwest the transportation credits are non-seasonal and are considered a marketwide service payment deducted from the pool. Then, similar to the Appalachian and Southeast FMMOs, transportation credits are established and adjusted monthly based on the difference between reported diesel fuel prices and a reference price (see appendix for detailed formulas).

Statistical Uniform Price⁹

In all FMMO marketing areas, the utilization of milk in Class I, II, III, and IV become the foundation for the value of milk in the marketwide pool. In the Appalachian, Arizona, Southeast, and Florida FMMOs uniform prices are based on this classified value and reflect the weighted average price of skim and fat used in the four classes.

In multiple component pricing orders, the difference between the classified value and the total handler obligation to producers pooling on the order represents the residual monies in the marketwide pool. The handler obligation is based on the pounds of butterfat, protein, and other-solids in the pool. If applicable, marketwide service fees are deducted from the pool, then the residual monies, positive or negative, are divided by total pounds in the marketwide pool to determine the producer price differential. Negative residual values result in negative producer price differentials. For producers pooling on multiple component pricing orders the regulated minimum price is based on the announced producer price differential, adjusted for location using Class I differentials, plus the value of the producer milk at test (butterfat, protein, other-solids, and somatic cell count).¹⁰

The proposed California order functions similar to a multiple component pricing order. First the

⁹ See § 1050.61 and § 1050.62.

¹⁰ Of the six multiple component pricing orders only the Mideast, Upper Midwest, Central, and Southwest FMMO marketing areas include somatic cell count adjustments.

classified value of milk in all four classes minus the fortification allowances is totaled.¹¹ Then, after deducting the value of quota and marketwide service payments (transportation credits), the remaining monies in the pool will be used to determine the regulated minimum prices for each of the milk components and the producer price differential. The determination of the California uniform milk price will depart in two important ways from FMMO pricing. First, similar to the Northeast and Pacific Northwest FMMOs, California will not include somatic cell count adjustments as part of the regulated minimum price.¹²

Second, and more importantly, the California pool will not have a conventional producer price differential. In lieu of a per hundredweight announced producer price differential, California uniform butterfat, protein, and other-solids component values will be adjusted up or down based on the residual value of the marketwide pool and will not be adjusted for location. The amount by which component prices will be adjusted up or down will be a function of each component's contribution to the Class III milk value at test during the prior fiscal year (December to November). Higher contributions to the Class III value will result in larger uniform component price increases (decreases) when the producer price differential is positive (negative). The component contributions will be announced prior to the computation of the uniform milk price and are fixed annually. Using CDFA component data and FMMO component prices, Table 1 shows the fiscal year variation and Figure 2 shows an estimate of the monthly variation in each components contribution to the Class III milk value at test from 2006 to 2013.

Table 1. Fiscal Year (December to November) Estimate of Component Contribution to the Class III Milk Value At Test, 2006 to 2013

| Fiscal Year (Dec to Nov) | Component Contribution to the Class III Milk Value at Test (Percentage) | | |
|-----------------------------|--|---------|--------------|
| | Butterfat | Protein | Other-Solids |
| 2006 | 40% | 53% | 8% |
| 2007 | 30% | 57% | 13% |
| 2008 | 31% | 66% | 2% |
| 2009 | 38% | 60% | 2% |
| 2010 | 44% | 50% | 7% |
| 2011 | 43% | 48% | 10% |
| 2012 | 35% | 53% | 13% |
| 2013 | 32% | 55% | 12% |

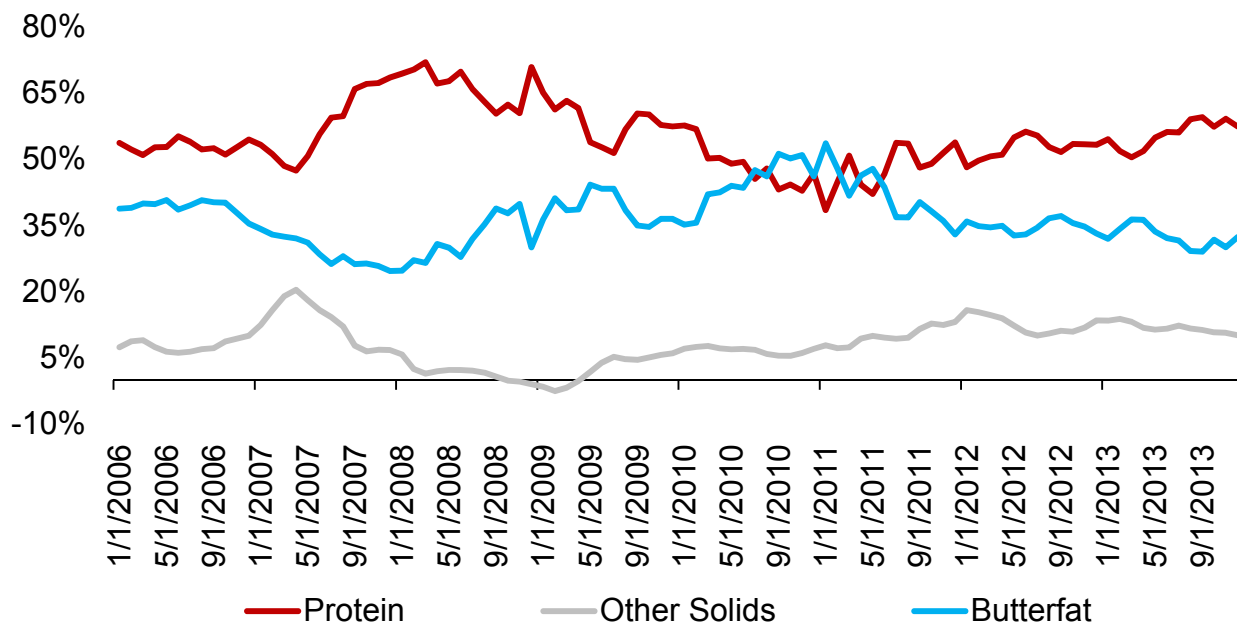
Once these uniform component prices are determined, the regulated minimum price will be the producer milk value at test using the uniform component prices. These uniform component prices will differ (positive or negative) from component prices enforced in other FMMO marketing areas. Then,

¹¹ For detailed fortification allowance procedures see § 1050.60. Depending on the product, California milk compositional standards require fluid milk to be fortified by replacing removed fat with solids-not-fat (e.g. [8.7% solids-not-fat in Grade A Pasteurized Milk and 9% solids-not-fat in Grade A Nonfat Milk](#)). California FMMO provisions recognize these standards and provide credits based on fortification when determining the handler's value of milk. Fortification credits range from \$0.00 to \$0.1985 per pound for nonfat dry milk and \$0.00 to \$0.0987 per pound for condensed skim. FMMOs do not provide fortification credits.

¹² See § 1000.50 for somatic cell count adjustment provisions. Farms with somatic cell counts below 350 receive per hundredweight premiums based on the announced protein price.

for producers holding quota, quota premiums in addition to this FMMO regulated minimum price will be enforced as the regulated minimum price.

Figure 2. Monthly Estimate of Component Contribution to the Class III Milk Value at Test, 2006 - 2013



Forward Contracting Provisions¹³

The need for forward contracting provisions was first recognized by Congress in the 2008 Farm Bill. The 2008 Farm Bill’s Dairy Forward Pricing Program allowed handlers regulated under FMMOs (not including California) to pay producers and cooperatives in accordance with the terms of a forward contract agreement. Handlers procuring milk for manufacturing classes using a forward contract were not bound to FMMO minimum price provisions. Fluid plants were not permitted to forward contract with farmers any amount of milk in excess of their non-fluid utilization. These 2008 forward contracting provisions provided the ability of dairy producers to self-manage their revenue risk. Forward contracting was subsequently prohibited in late 2013 when the 2008 Farm Bill expired.

Under the existing California state order provisions forward contracting of milk is not permitted. All Grade A handlers of milk in California must pay the minimum class price for milk. However, farmer-owned cooperative associations are not bound to similar forward contracting restrictions with their member producers. Thus, producers not selling milk to a cooperative-owned processing facility instead must turn toward futures and options contracts or USDA sponsored risk management tools to manage milk price risk. Given that both futures and options and USDA’s Livestock Gross Margin Insurance for Dairy are based on FMMO class prices, and not California state order prices, considerable basis risk exists for California farmers seeking to use these risk management tools.

¹³ The Dairy Forward Pricing Program was first authorized in section 1502 of the Food, Conservation and Energy Act of 2008.

The 2014 Farm Bill reintroduced and extended forward contracting provisions through September 2018. As a result, handlers regulated under FMMOs may enter into forward price agreements with producers or cooperatives and voluntarily forego FMMO minimum price provisions for milk in non-fluid classes. Thus, if FMMO provisions in California are adopted, by default the Dairy Forward Pricing Program would apply to California dairy producers and handlers. If a FMMO is adopted, handlers in California procuring milk for manufacturing classes would be able to negotiate terms of a forward contract and would not be bound to FMMO minimum price provisions. Importantly, the terms of a forward contract do not impact the ability of FMMOs to pool and determine the uniform value of milk. Producer milk under forward contract must still account to the pool for the classified and handler obligated value of the milk.

Summary

For nearly 50 years California has regulated its dairy industry under their own milk pricing plans and revenue pooling arrangements and has remained autonomous from the rest of the U.S. and the FMMO program. A recent proposal by California's three largest dairy cooperative seeks an end to the state-wide program in favor of joining the FMMO program. A FMMO would be expected to align California regulated minimum milk prices more closely with those reported, and enforced, in other FMMO marketing areas.

In many respects the proposal for a California state-wide FMMO mirrors the existing state provisions in that pool quota, fortification credits, mandatory pooling, and transportation credits all appear, albeit modified, in the FMMO proposal. Based on these interpretations, the primary deviation then from the current state order is the different regulatory pricing structure, determination of regulated minimum uniform prices, and the ability to forward contract milk in manufacturing classes. However, since this is an ongoing process interpretations may change if and when additional evidence is provided. The final rules would be determined after a FMMO hearing process if USDA finds sufficient evidence to warrant a FMMO. Dairy farmers in California would then be provided the opportunity to vote for adopting a FMMO.

With respect to a FMMO, the next step in the process belongs to USDA and to parties interested in [submitting an alternative proposal](#). Alternative proposals must be received by April 10, 2015. After conducting an analysis of the proposal(s), USDA will then decide if and when a hearing will be held. Given the scope of this proposal, a FMMO hearing could be a lengthy process (e.g. [FMMO Amendment Process](#)). To support California dairy producers in their FMMO efforts USDA plans to conduct a series of public outreach meetings throughout California in early May 2015. Additionally, USDA has maintained a [working document](#) highlighting questions and answers with respect to marketing order provisions and the rule making process.

References:

- U.S. Congress, House of Representatives, Agriculture Committee. 2014. Agricultural Act of 2014. House Document 2642, 113th Cong., 2nd sess. 4 February.
- U.S. Department of Agriculture, Agricultural Marketing Service. 2015. Federal Order Language – Order Regulating Handling Parts §1000 to §1131.
- , Agricultural Marketing Service. 2015. Attachment A Proposed Language for the California Milk Marketing Order.

Appendix - Transportation Credit Formulas:

California:

The mileage rate and transportation credit formulas follow:

$$(1) \quad MR_t = \frac{\frac{1}{8} \sum_{j=1}^8 d_{t-j} - 4.099}{5.8} \times \frac{1}{520}$$

$$(2) \quad TC_{t,1} = 0.04497 + \min(225, m) \times (MR_t + 0.00318)$$

$$(3) \quad TC_{t,2} = 0.00485 + \min(225, m) \times (MR_t + 0.00546)$$

$$(4) \quad TC_{t,3} = 0.05441 + \min(225, m) \times (MR_t + 0.00571)$$

Where MR is the mileage rate, d is the Diesel (on Highway) – All Types price per gallon as reported by the Energy Information Administration for California Number 2 Diesel Prices, and m is the shortest hard surface highway mileage between the shipping farm and the receiving plant.

Upper Midwest:

The assembly credit rate is given by:

$$(5) \quad TC = \max[0.28 \times \min(400, m) - \max(p_1 - p_0, 0), 0]$$

Where m is the miles between the transferor plant and the transferee plant, p_1 is the class I price at the transferor plant, and p_0 is the class I price at the transferee plant.

Appalachian and Southeast:

The mileage rate factor and transportation credit formula follow:

$$(6) \quad MRF_t = \left(\frac{\frac{1}{4} \sum_{j=1}^4 d_{t-j} - 1.42}{5.5} + 1.91 \right) \times \frac{1}{480}$$

$$(7) \quad TC_t = (m - \phi 85) \times MRF_t - \max(p_1 - p_0, 0)$$

Where MRF is the mileage rate factor, d is the Diesel Price per gallon as reported by the Energy Information Administration for the Lower Atlantic and Gulf Coast Districts combined, m is the shortest hard surface highway mileage between the shipping farm and the receiving plant, $\phi = 1$ if milk is received from a dairy farm and not a other order pool plant, and $\max(p_1 - p_0, 0)$ is the difference, if positive, in class I differentials.