Milk Marketing Orders: Background and Current Issues

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MILK MARKETING ORDERS: BACKGROUND AND CURRENT ISSUES

SUMMARY

Milk markets have been characterized by a chronic imbalance of supply and demand, which has potential negative consequences for both producers and consumers. It has been argued that persistent price instability, particularly when prices are depressed, can drive producers from the market and potentially damage the ability of the market to provide a dependable supply of quality milk to consumers.

Federal milk marketing orders were instituted in 1933 to promote orderly marketing conditions by, among other things, applying a uniform system of classified pricing throughout the market. Critics of the order system contend that milk orders have outlived their purpose, considering that producer cooperatives have improved dairy farmer marketing options and bargaining power, and advances in technology have broadened producer markets.

Federal milk orders regulate handlers that sell milk or milk products within an order region, by requiring them to pay minimum prices for the Grade A milk they purchase from dairy producers, depending on how the milk is used. This classified pricing system requires handlers to pay a higher price for milk used for fluid consumption (Class I) than for milk used in manufactured dairy products such as yogurt, ice cream, cheese and butter (Class II and Class III products).

The minimum price paid for Class I milk varies by order and is generally higher the more distant a region is located from the Upper Midwest. This distance differential was designed to make it profitable for Upper Midwest producers to ship their surplus milk to deficit markets and to avoid shortages in deficit regions. However, many producer groups in the Upper Midwest claim that the higher minimum prices dictated by Federal orders in non-traditional dairying regions such as the Southeast encourage excess local production and discourage the movement of surplus milk from other regions.

The U.S. Department of Agriculture (USDA) began holding national hearings on Federal milk orders in September 1990 to give representatives of producers, handlers, and consumers the opportunity to present their views on amending milk marketing orders. The majority of the more than 50 proposals received by USDA recommend changes in the way minimum prices should be set under Federal orders and how revenues should be distributed among dairy farmers. Among the many alternatives likely to be addressed in the amendment process are 1) the use of multiple basing points, 2) the consolidation of Federal order regions, 3) the removal of economic barriers to reconstituted milk, and 4) changes in the pricing of Class II products.

Since many of the proposed changes involve the redistribution of dairy farmer income among regions, achieving a consensus on reform of the order system may be difficult to accomplish. If substantive reforms are not accomplished through the amendment process, some dairy groups might seek changes in Federal milk marketing orders through legislative initiatives or legal challenges to the structure.
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BACKGROUND

Milk producers offer a commodity that is subject to certain unique marketing conditions. The market for milk is characterized by a chronic imbalance of production and demand. Milk demand tends to peak in the fall and winter months and decline in the spring and summer. Conversely, annual milk production generally is flush in the spring and summer following calving, but cows are less productive in the fall and winter months.

Because of its perishable nature, fluid milk must work its way quickly through the marketing chain and reach consumers within days of production. Any milk that is produced in excess of fluid needs is processed into manufactured products with a longer shelf-life, such as yogurt, ice cream, cheese, butter, and nonfat dry milk.

Dairy producers were long considered to be in a difficult marketing position that had the potential to lead to instability in the supply and price of milk. Before the institution of milk marketing orders in the 1930s, wide seasonal fluctuations in producer prices were quite common. Prices tended to be relatively high during the short-production months of the fall and winter and significantly lower during the spring and summer flush period. Dairy farmers frequently found it difficult to consistently meet consumer demand without falling into periods of costly overproduction. As a result, dairy handlers tended to cut off producers during the flush period.¹

The resulting wide fluctuations in the price of milk were generally considered to be undesirable for both producers and consumers of milk. It has been argued that persistent price instability, particularly when prices are depressed, could drive some producers from the market and potentially damage the ability of the market to provide a dependable supply of quality milk to consumers.

In response to these conditions, Federal milk marketing orders were first created in 1933, and received permanent authority under the Agricultural Marketing Agreement Act of 1937. A Federal milk marketing order has three

¹ A dairy handler is a processor or a distributor that purchases milk from dairy farmers, or their cooperative associations, either to distribute in fluid form or to manufacture into a dairy product. In many markets, a producer cooperative can also function as a handler.
broad objectives: 1) to promote the orderly marketing of milk; 2) to assure consumers an adequate supply of milk at reasonable prices; and 3) to develop stable prices resulting in improved incomes for farmers.

In brief, dairy handlers regulated under a Federal milk order are required to pay minimum prices for the Grade A milk they purchase from dairy producers, depending on the end use of the milk. Hence, it is primarily the handler that is being regulated by a Federal order, not the producer. Federal orders allow handlers to purchase milk from any producer, and also enable them to sell their processed milk at any price in any market.

Critics of the Federal milk order system contend that marketing orders have outlived their usefulness because milk marketing conditions are different today than they were in the 1930s. At that time, the dairy market consisted of a large number of farmers facing a small number of buyers. Consequently, individual dairy farmers could not influence the price of milk and were essentially "price-takers." Milk markets were also basically local in nature, due in part to the lack of both a highway infrastructure and refrigeration technology, which prohibited the shipping of milk over long distances. Critics point out, among other things, that since the 1930s, cooperatives have strengthened farmers' marketing position, and advances in refrigeration and other technology have also helped to broaden markets.

THE MECHANICS OF FEDERAL ORDERS

Milk sold by producers is classified into two grades: Grade A (fluid-grade milk) and Grade B (manufacturing-grade milk). The Federal milk marketing order system regulates minimum prices only for Grade A milk. Grade A milk accounts for 90 percent of all milk marketed in the Nation, and Federal orders regulate 80 percent of that amount (approximately 70 percent of all milk), through 42 separate marketing orders (see Figure 1). Another 17 percent of the fluid grade milk marketed in the United States is regulated by 13 separate State marketing orders, the largest of which is in California.

Federal milk marketing orders are administered by the Dairy Division of the U.S. Department of Agriculture's (USDA's) Agricultural Marketing Service (AMS). An order is initiated by dairy producers through their cooperative

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2 Producers of Grade A milk have more stringent sanitation standards than Grade B facilities. All fluid milk products (whole milk, lowfat milk, skim milk, buttermilk, and flavored milk drinks) must be processed from Grade A milk. Although Federal standards do not require manufactured dairy products such as cheese, butter, yogurt, and ice cream to be made with Grade A milk, more than one-half of the Grade A supply is used in manufactured products.

3 A Federal order for North Carolina and South Carolina was implemented on September 1, 1990, but is not depicted in Figure 1.
MARKETING AREAS UNDER FEDERAL MILK ORDERS AS OF JANUARY 1, 1990

Figure 1.
associations by petitioning the Secretary of Agriculture to regulate the pricing of milk in their region. The order formulation process includes: a preliminary investigation by USDA; a national hearing that allows producers, handlers, and consumers to testify; a recommended decision and order issued by USDA; followed by a final decision and final order. Before an order can be issued, at least two-thirds of the producers selling milk in the marketing area must approve the final order through a referendum. Once an order is established, it becomes a legally binding instrument regulating all handlers who sell milk or milk products within an order region.

The costs associated with administering a Federal order are defrayed by an assessment levied on handlers. The assessment ranges from 2 cents to 5 cents per hundredweight (one hundred pounds, or cwt.).

A 1971 amendment to the Agricultural Marketing Agreement Act of 1937 allows individual orders to engage in promotion, education and research activities, also financed through assessments on milk marketed under the order. Under the Dairy and Tobacco Adjustment Act of 1983 (P.L. 98-180), dairy producers are assessed 15 cents/cwt. for all milk marketed for generic promotion and related activities aimed at expanding the consumption of milk and dairy products. The law permits producers to take a credit of up to 10 cents/cwt. for payments to qualified State and regional marketing order promotion programs.

The 1937 Act gives USDA several authorities to achieve the objectives of the program. Two of the most significant features of a marketing order are 1) classified pricing -- whereby milk is classified by its use and handlers are required to pay a higher price for milk used for fluid consumption than milk for manufactured products, and 2) revenue pooling, whereby producer receipts within a marketing order are pooled and all producers in the order receive the same blend price for milk sold.

Classified Pricing

Although Federal orders indirectly influence the consumer price for milk, they do not regulate the wholesale or retail price of milk. Instead, orders require milk handlers to pay minimum prices to milk producers supplying fluid-grade (Grade A) milk.

Grade A milk sold within most orders is classified into one of three categories depending on its use. Milk used for consumption in fluid form is classified as Class I milk and receives the highest minimum price under the order system. Milk used for the production of manufactured products is included in two separate classes in most of the Federal order markets. Class II products (fluid cream, yogurt, ice cream, cream cheese, cottage cheese, and other soft manufactured products) use milk in their production that commands a lower price than milk for fluid consumption. The lowest minimum price is paid for milk used for hard manufactured products, such as
butter, nonfat dry milk and cheddar cheese, which receives a Class III price.\footnote{Although a three-class system is the most common among Federal orders, some have only two price classes. In such cases, all fluid products are assigned to Class I, and all manufactured products are considered Class II.}

The minimum prices paid by handlers for each of the three classes are adjusted monthly by AMS in tandem with changes in the market conditions for milk. The base price for the entire Federal order system is the Minnesota-Wisconsin (M-W) price, which represents the average price received by farmers in the two States for manufacturing grade (Grade B) milk. Monthly changes in the M-W price are directly translated into commensurate changes in all three price classes.

With a few minor exceptions, the minimum Class III price for a given month is equal to the M-W price for that month. This Class III price is essentially the same in every order nationwide. The minimum Class II price is the M-W price from two months earlier plus a variable differential in each order, that tends to average 10 cents per hundredweight (cwt.) plus an adjustment factor. The minimum Class I price in each order is equal to the M-W price from two months previous plus a fixed differential (the Class I differential), which varies significantly from order to order, and has been the source of considerable regional debate in recent years.

There are several reasons why the Federal order system places a higher value on milk that is purchased for fluid consumption than milk that ends up in manufactured products. Classified pricing recognizes that it is more expensive for the dairy farmer to produce and market fluid-grade milk than milk for manufactured products. The basic difference between Grade A milk and Grade B milk is that producers of Grade A milk must conform to more stringent sanitary standards, which could entail additional expenses. Moreover, transportation expenses associated with shipping fluid milk from production areas to metropolitan consumption areas can be expensive.

The classified pricing system was developed to assure that dairy producers supply a reserve of fluid milk to accommodate the daily fluctuations in demand. Milk that is delivered to the market to meet fluid demand is priced in the Class I tier and any surplus that is not needed for fluid use is used for manufactured products and is assigned a lower class price. By pricing only the reserve milk at a lower price than the fluid milk, classified pricing prevents such supplies from depressing the price of milk to dairy farmers to the point where the supply for a market may become endangered.

**Class I Differentials and the 1985 Farm Bill**

Historically, the Class I differential for each order (the difference between the Class I price and the Class III price) consisted of two major components: a Grade A differential and a distance differential. Other economic factors,
such as supply and demand of the market, and prices in competing nearby markets have also been reflected in the differential.

The Grade A differential was designed to compensate producers for the additional costs associated with upgrading their facilities to comply with Grade A standards. This factor has been a constant amount for each order and has recently been $1.04 per hundredweight (cwt.). Critics of the order system contend that production cost differences between Grade A and Grade B facilities are significantly less than $1.04. Since nearly 90 percent of the current milk supply is Grade A, critics maintain that the Grade A differential is no longer necessary.

A major component of the differential has been the cost of transporting fluid milk from a surplus region to the rest of the Nation, or the distance differential. When marketing orders were first instituted, the Upper Midwest\(^5\) was the Nation’s major dairying center and the greatest source of surplus milk. Hence, Eau Claire, Wisconsin was selected as the basing point for calculating the distance differential. From the late 1960s until 1985, USDA used a distance differential of 15 cents/cwt. for each one hundred miles a receiving plant was from Eau Claire. Thus, for marketing order regions east of the Rocky Mountains, those furthest from the Upper Midwest tend to claim the highest fluid milk prices. The distance differential was designed to make it profitable for Upper Midwest producers to ship their surplus milk to deficit markets and to avoid shortages in these regions.

The Food Security Act of 1985 (P.L. 99-198) increased the Class I differential in many orders (see Table 1). Because the distance differential remained constant at 15 cents/cwt., per hundred miles, for many years, while transportation costs were steadily rising, Congress acted to increase the differential in 35 of the then 44 orders so that minimum Class I prices would more closely reflect the actual cost of supplying the deficit markets. Congress recognized that handlers were generally paying more than the minimum price to cover the true cost of supplying the market, but that the amount of these over-order payments were inconsistent and contributed to market instability.

Although the mandated increases vary from order to order, the current differential in each order remains greater the more distant an order is from Eau Claire. For example, the highest differential is $4.18 in the Southeastern Florida order, while the lowest is $1.20 in the Upper Midwest order.

The Class I differentials established in the 1985 Act were to be effective for a two-year period ending May 1988. However, the Act allowed the mandated differentials to remain in effect indefinitely, unless they were modified by an amendment to the order. These differentials are still in effect.

\(^{5}\) The Upper Midwest generally refers to Wisconsin and Minnesota, which ranked first and fourth, respectively, in 1989 milk production. Combined, they accounted for 34 billion pounds, or 24 percent, of total U.S. milk production.
Table 1. The Food Security Act of 1985 Mandated Higher Minimum Class I Differentials for Most Federal Milk Orders

<table>
<thead>
<tr>
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<tr>
<td>- $ per cwt.-</td>
<td></td>
<td></td>
<td>- $ per cwt.-</td>
<td></td>
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<td>3.03</td>
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</tr>
<tr>
<td>Mid. Atlantic</td>
<td>0.25</td>
<td>3.03</td>
<td>Paducah</td>
<td>0.69</td>
<td>2.39</td>
</tr>
<tr>
<td>Georgia</td>
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<td>3.08</td>
<td>Memphis</td>
<td>0.83</td>
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</tr>
<tr>
<td>Alabama - W. Fla.</td>
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<td>3.08</td>
<td>Fort Smith²</td>
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</tr>
<tr>
<td>Upper Fla.</td>
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<td>Cent. Ark.</td>
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<td>Tampa Bay</td>
<td>0.93</td>
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<td>SW Plains</td>
<td>0.79</td>
<td>2.77</td>
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<tr>
<td>SE Fla.</td>
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<td>4.18</td>
<td>Tex. Panhdle.</td>
<td>0.24</td>
<td>2.49</td>
</tr>
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<td>Upper Mich.</td>
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<td>1.35</td>
<td>Lubbock</td>
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<td>S. Michigan</td>
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<tr>
<td>Ohio Valley</td>
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<td>2.04</td>
<td>New Orl.-Miss.</td>
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<td>SW Id.- E Oreg.</td>
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<td>S. Ill.</td>
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<td>1.92</td>
<td>Great Basin</td>
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<td>1.90</td>
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<tr>
<td>Louisv.- Lex.</td>
<td>0.41</td>
<td>2.11</td>
<td>Lake Mead³</td>
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<td>1.60</td>
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<td>Upper Midwest</td>
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<td>2.52</td>
</tr>
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</tr>
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<td>Kansas City</td>
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<td>1.92</td>
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¹ Changes became effective May 1, 1986.

² Merged with Southwest Plains order, effective May 1, 1987.

³ Merged with Great Basin order, effective April 1, 1988.

⁴ Merged to form the Pacific Northwest order, effective February 1, 1989.
and are a primary issue in the current amendment process. (See "Federal Milk Marketing Order Issues" below.)

**Revenue Pooling**

Although the price paid by a regulated handler varies depending on the use of the milk, producers themselves actually receive a uniform price each month for their milk. Rather than paying the producer directly, marketwide pooling requires a regulated handler to pay at least the minimum class price into a revenue pool. Producers then receive a weighted-average, or blend price, for the milk they sold, which is calculated monthly by a market administrator.

To illustrate how the blend price is calculated, consider the hypothetical case of three dairy processing plants operating in Kansas City that purchased 125,000 cwt. of Grade A milk from dairy producers during May. Of that amount, 60,000 cwt. is purchased by the cheese plant, 20,000 cwt. by the local ice cream manufacturer, and 45,000 cwt. by a fluid milk processor. The hypothetical M-W price for manufacturing grade milk was $12.75/cwt. in May and $12.70/cwt. in March.

The marketing order requires the cheese manufacturer to pay the Class III price of $12.75/cwt., (which is equal to the M-W price for May), into the order pool for the Grade A milk the plant purchased. Since the ice cream manufacturer produces a Class II product, the plant would pay $12.80/cwt., (March M-W price + a 10-cent differential, which can vary among orders and over time) for the milk it purchases. The fluid milk processor is required to pay the Class I price of $14.62/cwt. for its purchases, (March M-W price of $12.70/cwt. + the Kansas City order class I differential of $1.92).

The blend price received by all dairy producers selling to these regulated handlers during the month would be determined by multiplying the amounts used in each class by the respective class price, and then dividing the total value by the total volume:

<table>
<thead>
<tr>
<th>Class</th>
<th>Price</th>
<th>Volume</th>
<th>Value</th>
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</thead>
<tbody>
<tr>
<td>Class III</td>
<td>$12.75</td>
<td>60,000 cwt.</td>
<td>$765,000</td>
</tr>
<tr>
<td>Class II</td>
<td>$12.80</td>
<td>20,000</td>
<td>256,000</td>
</tr>
<tr>
<td>Class I</td>
<td>$14.62</td>
<td>45,000</td>
<td>657,900</td>
</tr>
<tr>
<td></td>
<td></td>
<td>125,000</td>
<td>$1,678,900</td>
</tr>
</tbody>
</table>

Blend Price = $1,678,900 divided by 125,000 cwt. = $13.43/cwt.

Therefore, if a producer sold 500 cwt. of milk, his payment would be $6,715 (equal to $13.43 X 500 cwt.), regardless of the end use of the milk sold.

The higher the Class I utilization rate in any order, the higher the blend price for that order. Once the fluid milk demand is satisfied within an order,
any surplus milk goes into the production of manufactured products, which command a lower minimum price than fluid milk. However, since producers receive a blend price, the surplus production does not depress the price received by producers as much as it would in the absence of the classified pricing provisions of Federal orders.

The Price Support Program and Federal Orders

The dairy price support program, administered separately from milk marketing orders, is another important Federal program that supports the income of dairy producers. The Agricultural Act of 1949, as amended by subsequent omnibus farm bills, requires USDA to support the farm price of manufacturing grade milk. USDA supports milk prices by its standing offer to purchase surplus nonfat dry milk, butter, and cheese from dairy processors. Prices paid to the processors are set at a level that will permit them to pay dairy farmers at least the Federal support price for their milk. As a result, Government purchases of these storable dairy products indirectly support the market price of milk for all dairy farmers.

When the market price of manufacturing-grade milk is above the support price, changes in the support price have negligible effects on the market price. However, when the market price of manufacturing-grade milk is at or below the support price any change in the support price will almost certainly affect the market price. Because all Federal orders derive their Class I price from the M-W price, and the M-W is a prime indicator of manufacturing-grade milk prices, the support price in effect undergirds the price of virtually all milk, including that for fluid consumption.

FEDERAL MILK MARKETING ORDER ISSUES

Although a primary goal of Federal milk marketing orders is to encourage the flow of milk from surplus production regions to deficit regions, some dairy producer groups contend that Federal order pricing policy actually discourages such movement of milk. The most vocal criticism of Federal orders has emanated from the Upper Midwest, where producer groups have expressed concern for many years that Federal orders treat their region inequitably, and are therefore in need of reform.

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5 Every 4 or 5 years, Congress considers omnibus farm legislation that establishes long-term farm policy and reauthorizes price and income support programs for various commodities. The most recent omnibus farm bill, the Food, Agriculture, Conservation and Trade Act (S. 2830), passed by Congress in October 1990, will not allow the support price to fall below $10.10/cwt. through 1995, and requires the Secretary to recommend an inventory management program under specified surplus conditions. See CRS Issue Brief The 1990 Farm Bill: Dairy Policy Issues (IB90030) for details.
Several legislators from upper midwestern States introduced legislation in the 101st Congress that addressed the perceived inequities of milk marketing orders. In the early months of 1990, pressure intensified to consider marketing order reform within the context of the dairy title of the omnibus 1990 farm bill. In addition to the heavy criticism of Federal orders launched by producer groups in the Upper Midwest, recent studies by the General Accounting Office and USDA's Economic Research Service have also recommended a comprehensive review of the pricing policy of Federal orders.

In response to the mounting criticism over Federal orders, USDA announced on March 29, 1990 that the agency would conduct national hearings on potential changes in milk orders. National hearings are one of the first steps in the lengthy administrative process of amending Federal milk orders by giving producers and handlers an opportunity to propose options for change. Any amendments to Federal orders must be approved by producers through a referendum. Implementation of any approved changes would not likely take effect until late 1991 or early 1992 (See "The Amendment Process" below).

Because of the complex nature of milk marketing orders, the Secretary of Agriculture maintained that perceived problems should be handled administratively rather than through the legislative process. Many dairy analysts considered the call for national hearings to be a landmark action, since past hearings have generally addressed issues affecting only individual orders. Following the USDA announcement of a national hearing, the pressure for a legislative remedy to the perceived problems gradually subsided, as critics appeared willing to use the hearing process as a vehicle for reform.

The current amendment process addresses issues that are national in scope including: 1) Class I differentials, 2) the pricing of reconstituted milk and, 3) Class II pricing. Separate from the national hearings, USDA will later consider reform of the M-W price as the base price for Federal orders.

Since many of the proposed changes involve the redistribution of dairy farmer income among regions, achieving a consensus on reform of the order system may be difficult to accomplish. If substantive reforms are not accomplished through the amendment process, some dairy groups may again seek changes in Federal milk marketing orders through legislative initiatives or legal challenges to the structure.

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6 Federal orders are permanently authorized under the 1937 Act, so they do not require periodic renewal by Congress.


Class I Differentials

Producers groups in the Upper Midwest have long contended that the current pricing system of Federal milk orders discriminates against them for two major reasons: 1) the Class I differential scheme of regions having higher Class I prices the farther they are located from Eau Claire, Wisconsin gives Upper Midwest producers the lowest minimum Class I price in the Nation and, 2) regional pooling of revenues and the payment of a blend price to producers based on the end use of the milk sold also contributes to low prices in the region since the Upper Midwest has one of the lowest Class I utilization rates in the Nation.

Because Federal orders establish a higher minimum price for fluid milk the further a region is from the Upper Midwest, critics contend that these mandated higher prices encourage too much milk production in high-cost regions such as the Southeast, Texas, and the Northeast at the expense of traditional dairy States such as Minnesota and Wisconsin. Since handlers must pay as much for milk shipped in from surplus regions as they would for local production, the critics maintain that there is no economic incentive to bring in milk from other regions, even if that region has a lower cost of production. Producers in regions with expanding production counter that population increases and favorable production costs are the major reasons for the higher output.

Critics of Federal orders also argue that increases in production in non-traditional dairy regions contribute to the national milk surplus at a time when Federal price support policy is attempting to discourage excess production and reduce Federal outlays on the purchase of surplus dairy commodities.

Because of the controversial nature of Class I differentials, USDA received at least 35 proposals prior to the national hearings that address Class I pricing policy. The proposals cover a wide array of options, ranging from separate proposals from the General Accounting Office and the Department of Justice calling in essence for the elimination of Federal milk orders to one proposal from a dairy cooperative recommending significant increases in all Class I differentials. Among the leading policy options affecting Class I pricing are the following:

Multiple Basing Points: Because the Upper Midwest is no longer the only region with surplus milk production, several producer groups have suggested that Class I differentials should be determined based on a region's distance from the nearest surplus region, rather than exclusively from Eau Claire. A surplus region is defined as any region that has a relatively low Class I utilization rate. For example, of the 10.8 billion pounds of milk delivered by producers in the Upper Midwest during 1988, only 14 percent was used for fluid consumption, with the balance going into manufactured
products, representing the lowest Class I utilization rate in the Nation. However, several other regions had relatively low Class I utilization rates.

A USDA study conducted in 1988 identified six regions (Lake States, Northeast, Corn Belt, Mid-Atlantic, Northwest, and Southwest) as potential basing points, by virtue of their having a Class I utilization rate under 60 percent. These six regions would then be assigned the lowest Class I differential. Proponents contend that multiple basing points would allow for greater market orientation by minimizing the influence of Federal order prices on regional production patterns.

USDA estimates that under a framework of multiple basing points, producer revenues would decline in nearly every region. Consequently, strong opposition to such a proposal has come from the Northeast region and the Southern deficit production region, which would experience significant declines in their Class I differentials and producer revenues.

**Single National Order:** Groups calling for greater uniformity in the implementation of Federal orders favor a single national order. The proposal represents an outgrowth of the perception that the Nation is one large market for milk and that regional orders are no longer necessary.

A national order could be structured a wide variety of ways and therefore has no fixed definition. One widely discussed option would provide for the formation of a national pool, whereby a single blend price would be calculated for all producers delivering milk under Federal orders based on the national utilization of milk in each class, rather than the regional usage.

A national order might include all States, even those that have State regulation of milk pricing and are currently not a part of the Federal order system. Many producer groups contend that California, the second largest milk-producing State but not now covered by a Federal order, should be regulated by Federal orders since all States are eligible to sell their surplus production to the Government under the Federal price support program.

A number of major roadblocks stand in the way of the formation of a national order. The Agricultural Marketing Agreement Act of 1937, as amended, which authorizes Federal milk orders, prohibits the formation of a national order unless the Secretary of Agriculture determines that separate orders do not achieve the objectives of the act.

Under a single national order with national pooling of revenues, regions that have a lower Class I utilization than the national average would receive a higher blend price and hence higher revenues. Conversely, those orders with a Class I utilization rate above the national average would be paid a lower blend price. Hence, the greatest obstacle would be getting those orders that currently have a higher blend price than the national average to agree to such a structure, since they would likely experience a reduction in blend price and producer revenues.
Order Mergers: Because of the potential problems associated with a national order, some groups are suggesting the merger and consolidation of Federal orders to fewer than the current number. Mergers have been recommended particularly for contiguous orders that have similar Class I utilization rates. Proponents contend that such a merger would streamline administration of the order, without causing a significant change in the blend price paid to farmers. Some groups are opposed to mandatory mergers and would prefer that such decisions be left to the discretion of producers.

Upper Midwest Coalition Proposal: A coalition of the largest Minnesota and Wisconsin dairy and farm organizations, dairy cooperatives, and State agencies presented a proposal on class I differentials at the national hearings that would: 1) set a base Class I differential of $1.80 in all orders and, 2) add a 15-cent to 30-cent surcharge on the Class I prices in each order to pay most of the cost of transporting milk to fluid processors in that market.

With a fixed transportation surcharge, all fluid processors would share equally in the total transportation costs of the market, and would draw money out of their pool to cover their transportation costs. Proponents consider this proposal to be a market-oriented approach that would increase prices just enough to cover the actual cost of hauling the milk. Because the southern and northeastern regions would receive significantly smaller differentials, the coalition contends that the plan would discourage surplus production in these regions and encourage the flow of milk within individual markets and between markets, since the pool would pay most of the transportation costs.

The coalition admits that the $1.80 base differential would contribute to an increase in the blend price for the Midwest orders and a reduction in all other orders. This implied redistribution of dairy producer income from the rest of the country to the Upper Midwest may hinder its acceptance.

Reconstituted Milk

Reconstituted milk is defined as a fluid milk product produced by adding water to condensed or dried milk components. One form of reconstitution can involve the recombination of milk’s component ingredients of nonfat solids, fat, and water. Recent advances in reconstitution technology have utilized a process called reverse osmosis, which allows processors to remove a large portion of the water content before shipping a long distance to a receiving market, where it can be added back prior to retail sale.

Many dairy groups argue that the pricing policy of Federal orders sharply reduces the economic incentive to reconstitute milk. They contend that without the economic barriers, producers in surplus production regions would find it more cost-effective to move their milk greater distances to deficit regions. Consequently, ten separate proposals were received by USDA
following its notice of national hearings recommending that the economic barriers against reconstituted milk be removed.

When a processor purchases either dry or concentrated milk for reconstitution, that purchase is subject to either "down-allocation" or "compensatory payments". These provisions require the processor to pay the difference between the local Class III price and the Class I price into the market pool for distribution to local producers. Because the processor is effectively paying the equivalent of a Class I price for a Class III product, and still must incur the cost of reconstitution, the total cost to the processor of the reconstituted milk becomes greater than purchasing local milk. In effect, all economic incentives to produce reconstituted milk are eliminated.

This effective penalty placed on reconstituted milk is designed to protect local producers by giving them first priority in supplying the fluid market. Many dairy analysts believe that without these payments, marketing orders could be subverted and local production would be displaced by the "importation" of reconstituted milk products from other regions, particularly from the Upper Midwest. Upper Midwest producers would recognize the greatest benefits from an easing of the economic restrictions on reconstituted milk, since transportation costs represent a significant cost of supplying deficit markets in the distant Southeast. Producer groups in the Upper Midwest contend that the protection and encouragement of local production by Federal orders and the restrictions placed on non-local reconstituted milk products further contributes to the national dairy surplus.

Several of the submitted recommendations call for the elimination of down allocation and compensatory payments. Very few producer groups want reconstituted milk to be treated as a Class III product, since such treatment could circumvent the Federal order system, and local production could potentially be displaced by the cheaper reconstituted milk from other sources. Consequently, many of the recommendations call instead for reconstituted milk to be treated the same as whole fluid milk, with respect to classification and pricing. Rather than paying the equivalent of the Class I differential into the receiving pool, as done currently, the source market would be paid its respective Class I price plus transportation costs. Upper Midwest producers argue that this would allow for the higher Class I prices enjoyed by other orders to be shared with their region. Proponents also argue that the elimination of the disincentives would allow the marketplace to decide whether it is efficient to ship reconstituted milk.

A USDA study determined that the removal of economic barriers to shipping a 50 percent milk concentrate (removal of one-half of the water content through reverse osmosis) would contribute to a redistribution of income from deficit production regions to surplus production regions. Although removal of barriers would have negligible effects on farm milk prices, it would contribute to a 5 percent increase in production in the Upper
Midwest, a 2 to 3 percent rise in the Northern Plains and California, and a 12 to 21 percent decline in the southern deficit regions, according to USDA.

An important variable to the debate is the consumer acceptance of reconstituted milk. Opponents are concerned that consumers may reject reconstituted milk out of fear that the technology might alter the taste or composition of what many view as a pure and wholesome product. Even if the Federal order system eliminated the economic restrictions, many States have laws or regulations that prohibit or restrict reconstituted milk. There is also concern among some groups that processors of reconstituted milk in the receiving market might add back more water than is removed at the source which would reduce the concentration of protein and other nonfat solids. Minimum standards for nonfat solids would have to be established to account for that possibility.

Class II Pricing

Many producers that supply milk for use in Class II products (fluid cream, yogurt, ice cream, cottage cheese and other soft manufactured products) contend that the current Class II differential, which ranges from 5 to 30 cents/cwt., is not sufficient to compensate them for what it costs to supply the market. As a result, many of the 12 proposals on Class II milk prices received prior to the national hearings suggest new formulas for determining Class II differentials.

Producers of milk for Class II products maintain that Class II products are more closely akin to fluid milk (Class I) products than hard manufactured products (Class III) and therefore should command a price closer to that of Class I products for several reasons: 1) Like Class I products, most Class II products also require a Grade A milk supply, which imposes more stringent standards on the dairy operation; 2) Class II products are semi-perishable with a shorter shelf-life than Class III products, meaning that inventories cannot be accumulated to balance demand patterns; and 3) Processors require special services of the producer, such as scheduled delivery.

Because of these conditions, several producer groups recommend that the Class II differential be increased, with the average recommendation calling for a 50 cent differential. Because the Class II market crosses over many orders, some groups suggest a national pooling of Class II revenues, so that market receipts are shared equally among all producers supplying the market.

Other proposals call for a change in the procedure used for calculating the Class II differential. Currently, the differential is determined in advance, but at a slightly later date than the Class I differential. For example, the

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Class II differential for July is based on the M-W price for May plus 10 cents plus or minus the change in milk equivalent values of selected dairy products between May and June. Proposals have been submitted to have the Class II price differential calculated in the same manner and at the same time as the Class I differential so that processors can make their pricing decisions on Class II products at the same time they price their fluid products.

Although there is not much opposition to correcting the timing and marketing imbalances associated with Class II pricing, processor groups and consumers will likely take issue with an increase in the differential. Some suggest that a 40 cent increase in the differential would lead to higher consumer prices for soft manufactured products. Processor groups are concerned that such an increase, coming at a time when the market for Class II products is rapidly expanding, may damage sales opportunities.

The M-W Price

USDA announced in July 1990 that it will hold a separate national hearing to review alternatives to the M-W price, the average price paid to farmers in Minnesota and Wisconsin for manufacturing grade (Grade B) milk. The M-W pricing formula was established in 1961 and has been used as the base price for all Federal orders since 1975. Considering that only a small percentage of milk produced today is Grade B, many groups have begun to question the continued relevance and reliability of the M-W price as a base for milk pricing. USDA officials admit that by mid-1992 there may not be enough Grade B milk marketed to develop a reliable base price.

A 1989 study by the General Accounting Office suggested five alternatives to the M-W price:

- a regulated Grade A manufacturing price series that would operate like the current M-W price except that Grade A milk used in manufacturing under milk marketing orders, as well as Grade B milk, would be included in the series;

- a deregulated Grade A price series that would also operate like the current pricing mechanism except that prices for Grade A milk used in manufacturing from outside the Federal order system would be used;

- a product formula that would derive milk’s value from dairy product prices,

Since the Class II price is based on the M-W price of two months previous and the Class III price is the current M-W price, it is possible that the Class II price could be lower than the Class III price in a given month, if milk prices are rising rapidly. In that event, the difference between the two prices would be added to the next month’s Class II price.
• an economic formula that would use the consumer price index, production costs and other economic indicators;

• or an administratively determined price that would be set through a committee, hearing, or panel.\footnote{See GAO Report Milk Pricing: New Method for Setting Farm Milk Prices Needs to Be Developed. Report No. GAO/RCED-90-8. November 1989.}

Dairy analysts project that the first option, calling for a new competitive pay price, and the third option, the product formula approach, will likely be given the most serious consideration by USDA as viable alternatives to the current M-W price.

Proponents view the competitive pay price option as the best of both worlds, since it would retain the basic structure of the current M-W price, but would reflect market conditions more closely by including Grade A milk. Critics argue that continuing to limit the pricing scheme to Minnesota and Wisconsin is not representative of national market conditions.

The product formula approach would review the wholesale prices of manufactured dairy products and calculate the value of the milk that went into the production of those products. Advocates of such a system argue that it most closely reflects market conditions, since wholesale prices are competitively determined. Others are skeptical about a formula that translates wholesale prices into farm prices, contending that the determination of the value added by manufacturers may be arbitrary.

The Food, Agriculture, Conservation and Trade Act of 1990 (the omnibus 1990 farm bill), requires USDA to publish in the Federal Register a proposed replacement price series by October 1, 1991 for 30 days of public comment, based on recommendations it receives through the hearing process. After the comment period, the Secretary of Agriculture would be required to publish a final rule to be reported to the House and Senate Agriculture Committees, and 30 days later would be required to implement the new series.

THE AMENDMENT PROCESS

When existing milk marketing orders are amended, as is currently being considered, the same procedure is followed as if a new marketing order is being proposed. The process can be summarized in six steps: 1) pre-hearing procedures, 2) the public hearing, 3) the recommended decision 4) the final decision, 5) producer approval, and 6) the issuance of the order.

**Pre-Hearing Procedures:** Although any producer or handler can petition USDA for a change in the Federal order system, such a request usually emanates from dairy producers or their cooperative associations.
USDA then investigates their proposals and determines whether a hearing is necessary. The amendment process requires that a formal notice of a hearing be published in the Federal Register, giving the time and place of the hearing and the proposals to be considered. The July 17, 1990 Federal Register contains such information for the current amendment process, as well as synopses of the more than 70 proposals that the agency received from interested individuals, companies, agencies, and corporations.

Public Hearing: Because these proposed changes affect all Federal milk orders, USDA scheduled hearings at several locations around the Nation. The principal participants at the hearing are representatives of producers, handlers, and consumers, who appear as witnesses and present evidence on how a proposed change in an order would affect their interests. The hearing is presided over by a USDA administrative law judge, who handles procedural questions and decides on the order of witnesses. Except for official documents, the public hearing record is the sole source of information for appraising the issues. At the close of a hearing, the judge presiding over the case sets a time period within which written briefs can be filed by witnesses.

Recommended Decision: After the hearing, the record is turned over to the dairy division of AMS for study and the preparation of a recommendation on the issues. The preparation time varies depending on the complexity of the issues. Because these particular proposals are comprehensive and controversial, a decision recommendation will not likely be reached until late summer 1991, at the earliest. This proposed decision will be made public by the Administrator of AMS in order to give interested persons an opportunity to appraise the potential effects of the amended order before it is drafted in final form, and to file written exceptions to the provisions of the amended order.

Final Decision: The dairy division is required to re-examine the findings and conclusions in light of the exceptions received and then provide a draft final decision to the Secretary of Agriculture for his review, approval and issuance. The provisions of the order contained in the decision represent USDA's final proposed regulations and are the provisions presented to producers for their approval. Such a decision in this round is likely to be reached in late 1991 or early 1992.

Producer Approval: Before an amended order can be issued, producers must approve it by a referendum. The percentage of eligible producers needed to approve an order depends on the type of pool established. A marketwide pool must be approved by either two-thirds of the eligible producers, or by

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producers who supply two-thirds of the milk sold in the marketing area. For an individual handler pool, the approval of both three-fourths of the eligible producers and producers who supply three-fourths of the milk in the region is required. The producer vote on the final decision would likely take place approximately one month after the decision is issued.

A dairy cooperative may block vote its membership on all questions involving new or amended orders. For instance, if the cooperative votes in favor of an order, all producers within the cooperative are considered to have voted for the order.

An important feature of the approval process is that producers are required to vote on the order as amended, not just the amendment to the order. As a result, producers are faced with an all-or-nothing proposition once the order is amended. This requirement is not spelled out explicitly in the statute. Instead, it represents a USDA regulation and interpretation of the law.

Although the amendment process usually allows for conflicting views to be worked out in advance of the final vote, producers conceivably may have to choose between an order with which they are dissatisfied, and no order at all. According to a USDA official, the agency and producers occasionally reach stalemates, particularly on contentious issues such as those currently being considered, but this has never resulted in a rejection of an order.

**Issuance of the Order:** The Secretary issues the order if the proposed order is approved by the required number of producers. Handlers are then required to operate in compliance with the terms of the order, within approximately one month. If the tentative agenda is followed, the final order would be issued in May 1992. However, the omnibus 1990 farm bill enacted in October 1990 requires the Secretary to complete implementation of any changes "to the maximum extent practicable" by January 1, 1992.