

Is Current Dairy Pricing System Relevant in Today's Industry?

Mark Stephenson, *Director of Dairy Policy Analysis*

What Is Special About Milk?

- It's perishable
- It's bulky
- It's produced and must be sold 365 days a year
- Specialized assets for production
- Many more sellers than buyers
- Relatively inelastic demand for products
- Historically led to “destructive competition”

- Market Failure

Cooperatives Came First

- 1804—Connecticut Dairy Farmers form first milk marketing cooperative.
- 1880-1901—Classified pricing and pooling introduced in Boston market.
- Early 1900s—New England cooperatives develop “base ratings plan” designed to ration access to Class I value.
- Early 1900s—Flat rate pricing gives way to 10 mile zone pricing. Milk moving as much as 400 miles by rail.
- Ability of cooperatives to bargain effectively erodes prior to and during great depression.
 - Most people convinced that cooperatives can't do it alone.
- **Agricultural Adjustment Act of 1933 amended in 1935 first authorizing marketing orders.**

Federal Orders

- Federal Milk Marketing Orders act like a traffic cop to regulate the terms of trade between farmers and handlers
- They are all about regulating **Fluid Milk**... Manufactured dairy products are welcome to come along for the ride
- “**Order**” and “**Equity**” are the goals (market efficiency is a measure of success in achieving the goals)
- **Classified Pricing** and **Pooling** are the tools
- It sounds easy, but it is actually very difficult to do. It's hard to know that you got it right, but you have plenty of evidence when it isn't.

Many Unique Aspects of FMMOs

- Federal Orders are voted in or out only by dairy producers.
- Only dairy processors are regulated
 - Class I processors must be regulated
 - Manufacturing processors may be regulated
- Very open hearing process

USDA issues a balanced and fair recommended decision to be voted on by producers.

The vote is for the whole order, or nothing—not just the change.



Classified Pricing

- Class I – generally highest price
 - Class II
 - Class III
 - Class IV – generally lowest price
- 

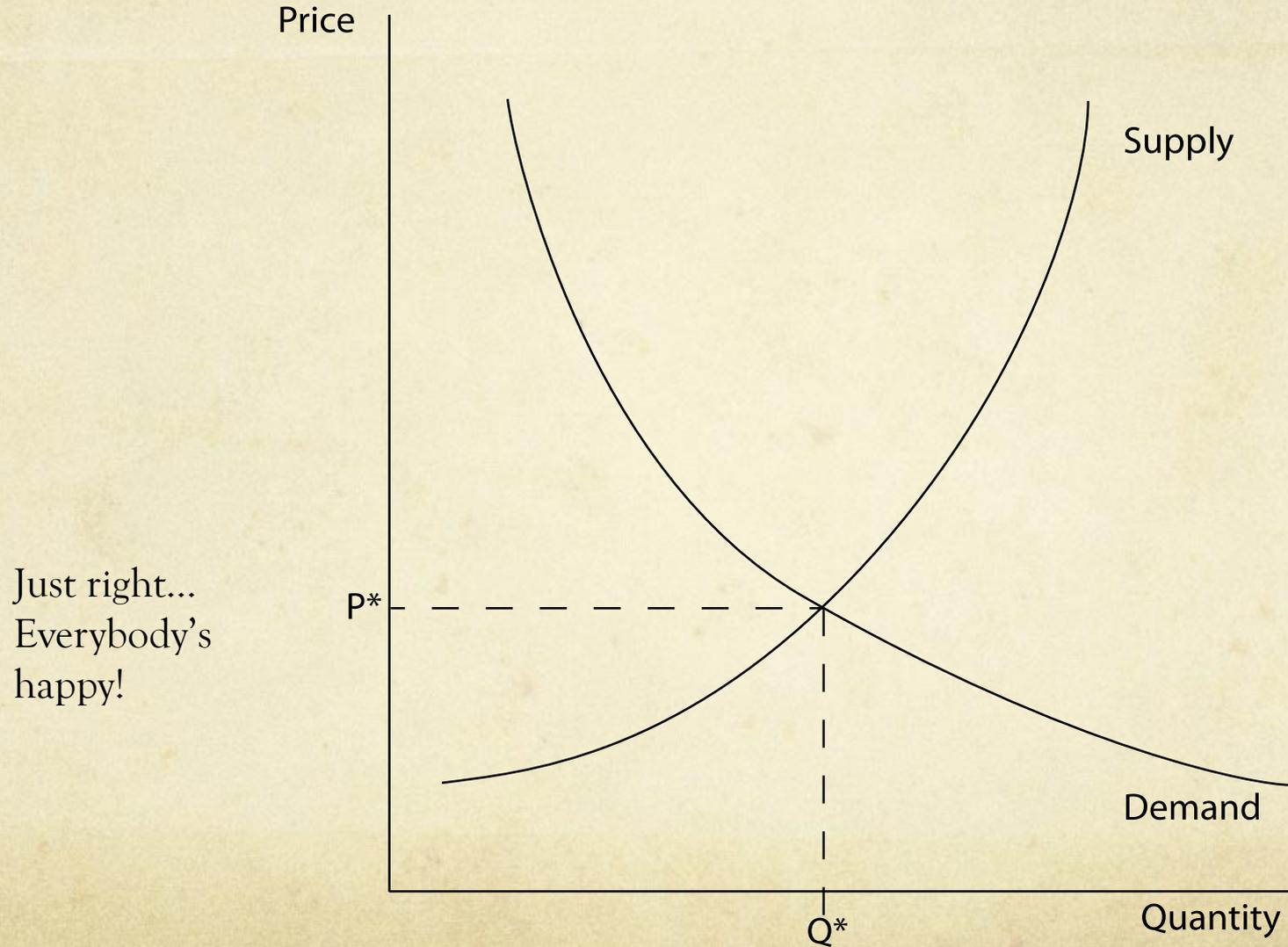
What is consistent with this ordering?

These are minimum prices to be paid!

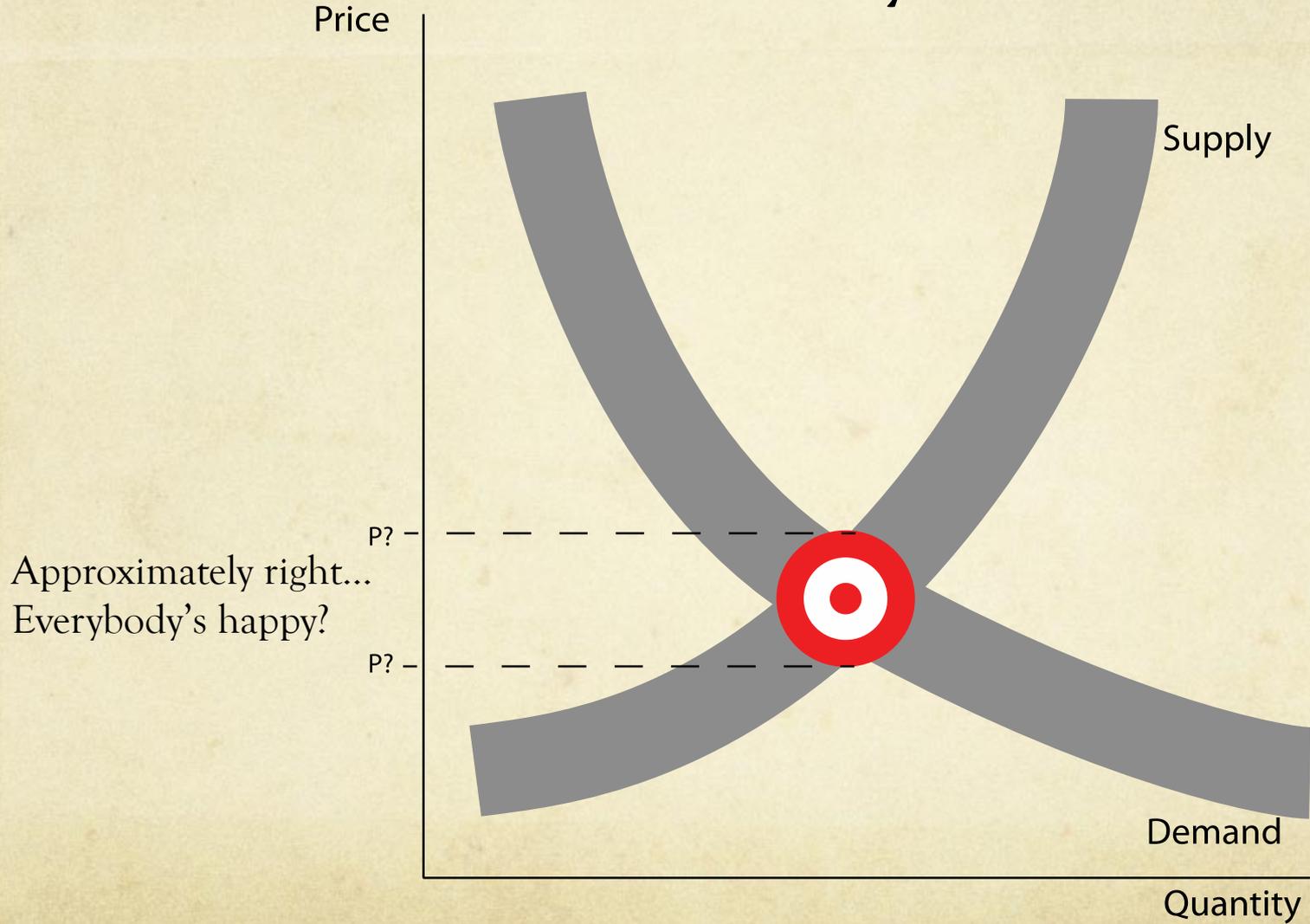
Why Classified Pricing?

- Many have said that it is to exploit the elasticity of demand.
- My read of history—going back to early cooperatives—is that it reflected high service costs (higher than average price)
 - Get extra milk when needed
 - Push extra milk away when not desired (summer, weekends)
- Balancing plants must be compensated for operating non-optimally (lower than average price)

Economist's View



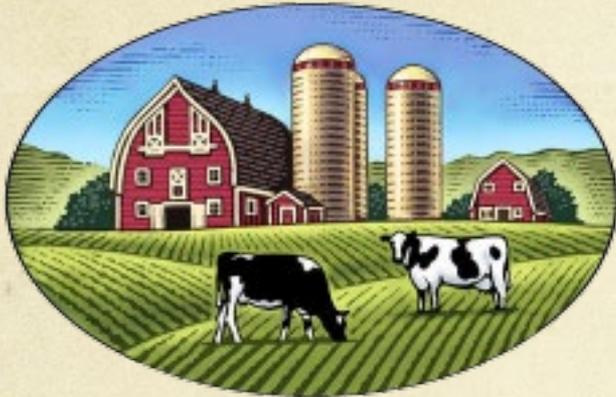
Reality



Options for Setting Milk Prices

- Competitive Pay Price
 - Gold standard, but hard to achieve
- **Product Price Formulas**
 - **Competitive Pay Price moving one step up the marketing chain**
- Administratively Determined
 - Single entity that sets the price
- Economic Formulas
 - Always discussed, seldom employed
 - Dairy Price Support Program

Marketing Chain



Product Price Formulas

Wholesale Price



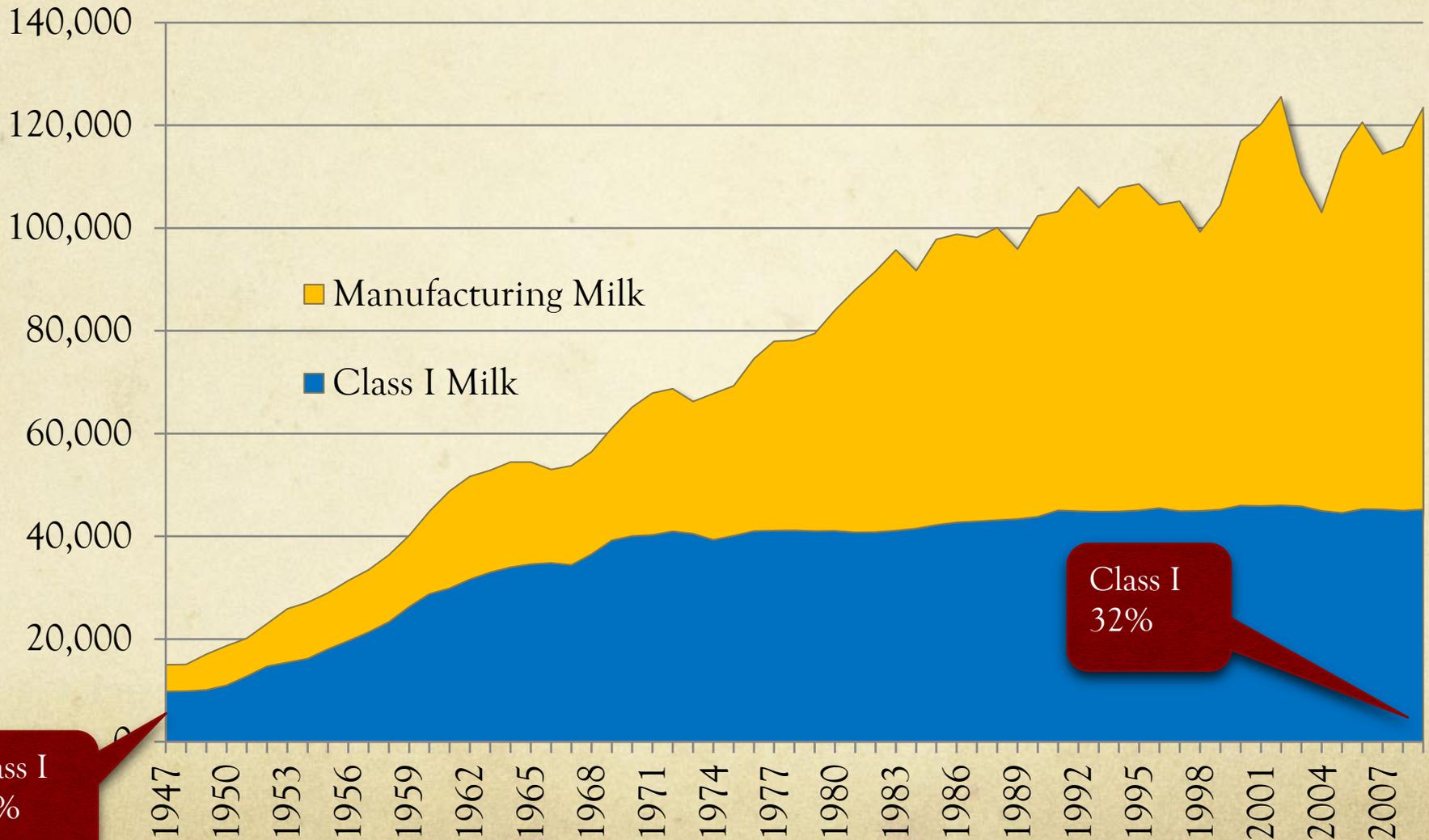
Premiums often paid (over order)

- Quality (somatic cell, bacteria)
- Volume
- Protein
- Plant or Market
- Hauling subsidies

Deductions usually made

- Checkoff (advertising)
- Milk Hauling
- Cooperatives Working Together (CWT)
- Coop Dues and/or reblending
- Others

Milk Use Has Changed



Class I
65%

Class I
32%

Not Much Money in FMMOs

- A \$3 differential on top of a \$5 manufacturing price when Class I utilization is more than 60% was a lot of money (26% of your milk check)
- A \$3 differential on top of a \$16 manufacturing price when Class I utilization is less than 30% is not so much money (5% of your milk check)
- In regions like the Upper Midwest or California the value is much less (about 1%)
- Do farmers have as much reason to fight for FMMOs?

Federal Order Issues

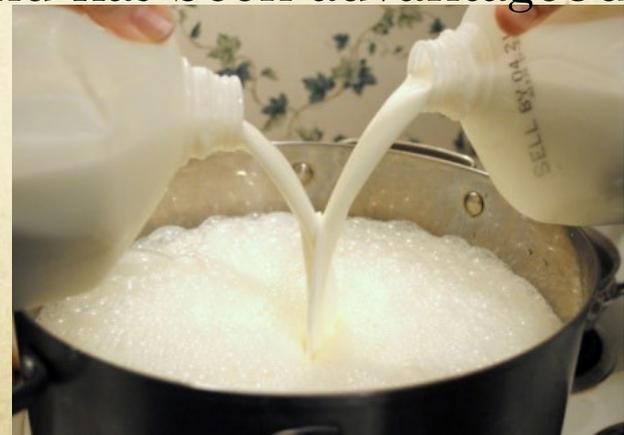
- Processors need relief in the make allowance
 - Find relief with lower premiums
 - Find relief with full or partial de-pooling
- Producers have been facing large negative PPDs
- Milk doesn't flow easily across different classes
- Farms absorb almost all of the volatility
- Pooling requirements have become a low hurdle

Observations

- FMMOs were conceived of and built for a time when everyone had pretty much the same problem.
 - Much more homogeneous farm size, technology and cost structure
 - If there was a problem in the past it was likely that everyone was experiencing that problem
 - Very different today
 - Regions have unique issues
 - Different farm sizes have different problems
- The existential issue for farms today may be access to markets.

Averages Mask a lot of Problems

- FMMO pooling provides everyone with a weighted average price. It doesn't send you a signal as to what the market really needs.
- Pooling within a cooperative doesn't send a signal about the marginal value of milk—i.e., spot prices to move milk.
- Pooling of both kinds has shared the marginal value of new milk across all producers and has been advantageous for growth-oriented farms.



Next Steps...

- Current FMMOs are a fluid milk solution to a set of manufacturing problems.
- We need to address some of the current issues or FMMOs will no longer be relevant or helpful.
- Make sure that we identify and address the problems and not the symptoms.
 - Negative PPDs are a symptom, not the problem
 - Make allowances are a symptom, not the problem
- Painful as it will be, the problems need to be addressed through a national hearing and not legislatively.

Long-Term Perspective...

- Imagine a world without Federal Orders
- Don't be in too big a hurry to get rid of them
- Pricing and pooling are not the only things that FMMOs do
 - Testing, calibration, auditing, market news, etc.
- What would your world look like without FMMOs and is that a world that you would like to live in?



Questions?