

Return to Competitive Pay Pricing For FMMO Class II – IV Milk Pricing Formulas

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Presentation Summary

- Why we are here:
 - MDIA as Sponsor of Proposal to Amend Class II-IV Product Pricing Formulas
 - Recommendation for Committee action to advance the proposal

- Law and Economics of Amending Class II – IV Milk Pricing Formulas

- Legal Background – Distinguishing the Need for Congressional Action from Agency Action to Implement Change to Pricing Formulas
 - Agency Action and Change
 - 1960-2000
 - 2007 Hearing Process to Implement New Competitive Pay Price

- Economics of Change to Competitive Pay Pricing
 - Identifying the Best Milk Pricing Formula – Options and Challenges
 - Competition for Milk and Competitive Pay Pricing
 - Next steps in the discussion
 - Issues for the Committee's further Review

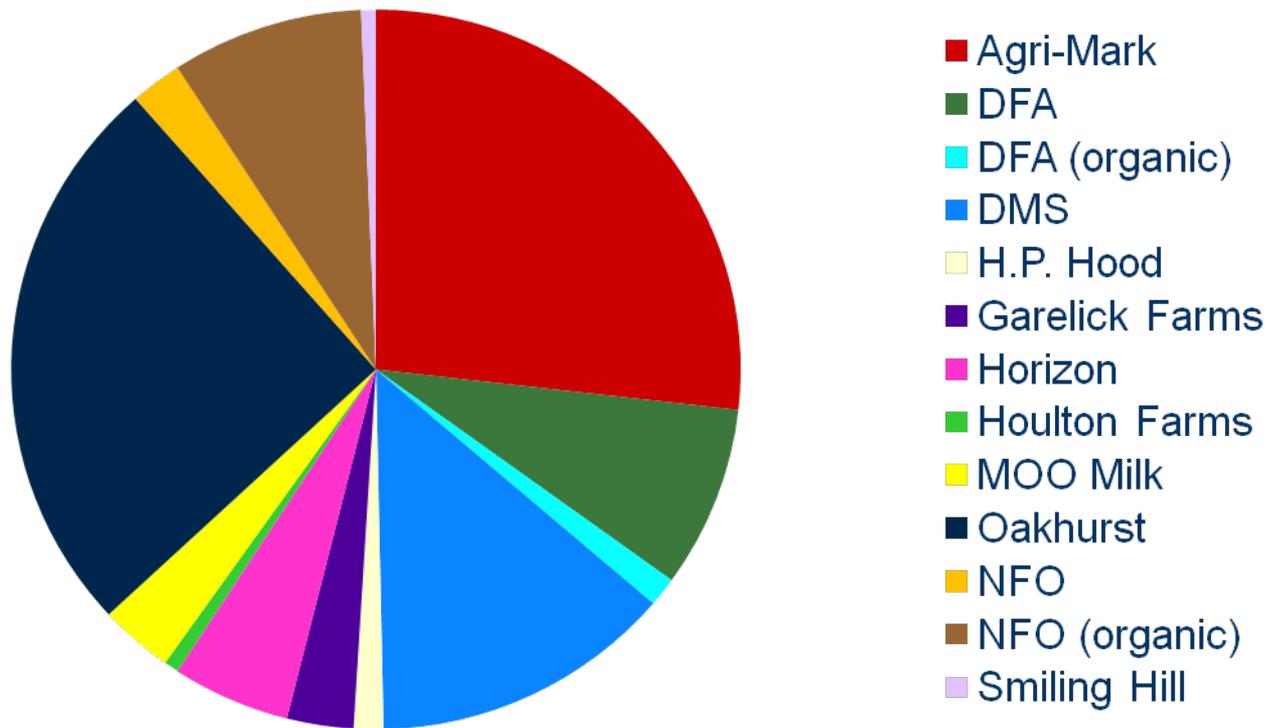
Maine Dairy Industry Association

- By state statute, MDIA represents all Maine dairy farmers shipping milk on commercial markets
- Funded by mandatory \$0.01/cwt assessment; producers may contribute up to \$0.04/cwt as voluntary payments
- Governed by a Board of Directors made up of producers representing all milk marketing sectors
- Staff and Board Members are active in local, state, national policy discussions involving dairy farming, processing and marketing
 - On-going appearance before Maine Milk Commission regarding state over-order price regulation
 - Promoted adoption of tiered state price support program

Maine Dairy Industry and Its Economic Impact

- Dairy is the number 1 agricultural commodity in Maine
- \$570 million total industry annual impact to ME economy
- \$25 million/year paid in state & local taxes
- 306 farms – producing 590 million pounds/yr = 69,600,000 gallons of milk - 31,000 cows = a return of \$17,000 per cow
- 4000 jobs generating \$150 million of earnings for Maine citizens
- over 60 processors = \$225 million/annual sales
- 700,000 acres of total dairy-related farmland in Maine (includes hay, grain, pasture, and rented land) valuing \$1,365,000,000
- 100% of Maine milk is artificial hormone rBST-free = niche market
- Maine has largest % of organic farms in the U.S. – 21%
- Artisan cheeses, naturally raised beef & hay sales = expanding value-added opportunities for dairy farmers

The Market for Maine Milk



Maine's State Price Support Program



dairy farmers

Recommended Committee Action to Advance Development of the Proposal

- Review of Proposal by Subcommittee Considering “ Options Under Current Law”
- Receive Comment on MDIA Proposal by Industry and USDA

Legal Change and Class II – IV Milk Pricing Formulas

- Statutory Change by Congressional Action + Agency Mandates
 - Change to the Support Price
 - Reducing Numbers of Federal Orders

- Agency Action Without Congressional Action
 - Consistent with Existing Statutory Authority
 - Amendment of Pricing Formula

7 U.S.C. § 608c(18)

(18) Milk Prices.

The Secretary of Agriculture, prior to prescribing any term in any marketing agreement or order, or amendment thereto, relating to milk or its products, if such term is to fix minimum prices to be paid to producers or associations of producers, or prior to modifying the price fixed in any such term, shall ascertain the parity prices of such commodities. The prices which it is declared to be the policy of Congress to establish in Section 602 of this title shall, for the purposes of such agreement, order, or amendment, be adjusted to reflect the price of feeds, the available supplies of feeds, and other economic conditions which affect market supply and demand for milk or its products in the marketing area to which the contemplated marketing agreement, order or amendment relates. Whenever the Secretary finds, upon the basis of the evidence adduced at the hearing required by section 608b of this title or this section, as the case may be, that the parity prices of such commodities are not reasonable in view of the price of feeds, the available supplies of feeds, and other economic conditions which affect market supply and demand for milk and its products in the marketing area to which the contemplated agreement, order, or amendment relates, he shall fix such prices as he finds will reflect such factors, insure a sufficient quantity of pure and wholesome milk to meet current needs and further to assure a level of farm income adequate to maintain productive capacity sufficient to meet anticipated future needs, and be in the public interest. Thereafter, as the Secretary finds necessary on account of changed circumstances, he shall, after due notice and opportunity for hearing, make adjustments in such prices.

FMMO Pricing Series, 1960 to the Present

- 1961: Department adopt the M-W Pricing Series
- 1994: Department replaces M-W with BFP
 - declines to adopt end product pricing formula
- 1996 - 2000 FAIR ACT Milk Market Order Reform: Department adopts end product pricing
 - rejects competitive pay pricing

MDIA Competitive Pay Price Proposal and FMMO Hearing Process

- February 2007: USDA, Dairy Programs, Order Formulation and Enforcement initiates hearing on Proposals to Amend Product Pricing Formula
 - Issue #18: MDIA Proposes to Replace End Product Pricing with Competitive Pay Pricing
- June 2008: USDA Issues Tentative Partial Final Decision including, among other actions, the rejection of MDIA proposal
- 2008 – Present: MDIA further develops the proposal to respond to Agency concerns and to broaden industry discussion, with ultimate aim of USDA Hearing

The Economics of Change

What's The Problem?

1. Most Grade A milk is regulated by Federal milk marketing orders.
2. Federal milk marketing orders:
 - a. Classify milk base on how it is used. (Class I, Class II, Class III and Class IV).
 - b. Set different prices for each class of milk use.
 - c. Pool the proceeds from all classes of use among all producers.
 - Dairy farmers in most markets must be paid the Class III price, plus the Producer Price Differential (PPD).
 - d. Audit and verify the uses of milk and the payments made for milk.

‘ What’ s The Problem?

3. How do you find the right price for each class of milk?
4. How can dairy farmers be assured that the price they receive accurately reflects the market for milk?

Alternative Ways To Set Milk Prices

1. Survey prices actually paid to farmers by buyers of milk.
2. Use open-market prices for dairy products, adjusted for yields and manufacturing costs.
3. Survey prices paid for dairy products, adjusted for yields and manufacturing costs.
4. Cost of producing milk.

Survey of Prices Actually Paid To Farmers By Buyers Of Milk

1. Method used to determine the Minnesota-Wisconsin (M-W) price.
2. Was used in Federal milk orders for almost 40 years.
3. Based on prices reported to be paid for Grade B milk by hundreds of buyers in Minnesota and Wisconsin.
4. Represented the degree of competition for Grade B milk at the time.

Survey of Prices Actually Paid by Buyers of Milk

4. Was not greatly distorted by the regulated market for Grade A milk.
5. The M-W price became the regulated price for manufacturing milk (Class III under the present classification system).
6. Became obsolete as the volume of Grade B milk declined.

Use Open-Market Prices For Dairy Products

1. The only credible open market for dairy products is the Chicago Mercantile Exchange (CME).
2. The CME is not trusted by many farmers and politicians because only a few firms buy and sell on the exchange.
3. Prices established on the CME are widely used by buyers and sellers of dairy products to set their own private treaty prices.

Use Open-Market Prices For Dairy Products

4. Dairy product prices are not the same as milk prices. They represent much, but not all, of the demand for milk. They reflect, but do not represent, the forces that influence the supply of milk
5. The dairy product prices must be put into a formula which includes the yields expected for each product, and the estimated costs of manufacturing that product.

Use Open Market Prices For Dairy Products

6. This method is very difficult to make work because:
 - a. The market for individual dairy products is not the same as the market for milk.
 - b. The dairy product prices used may represent only part of the total supply of that product.
 - c. Open-market prices are not available for many products, such as mozzarella cheese.

Survey Of Prices Paid For Dairy Products

1. System used since Federal order reform in 2000.
2. The National Agricultural Statistics Service (NA SS) surveys the prices sellers of bulk cheddar cheese, butter, nonfat dry milk and dry whey receive each month.
3. This option has all the weaknesses of using open-market dairy product prices, except that the number of firms reporting may be larger.
4. Several USDA hearings have been held in the last 10 years to determine the correct yields and manufacturing allowances to be used in the price formulas. There is little satisfaction with the results.
5. This option has the additional weaknesses of being less timely than the daily reporting of open-market prices.

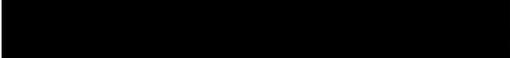
Cost of Production For Milk

1. The cost of producing milk is a major determinant of the supply of milk.
2. It is not the only determinant of the supply of milk. Other determinants include:
 - a. The costs and returns to other, alternative agricultural enterprises.
 - b. The expected returns from off-farm investments.
 - c. The availability of off-farm employment.
 - d. The mix of fixed and variable costs on a particular farm.
 - e. Etc.

Cost of Production For Milk

3. Costs of production vary greatly from farm to farm and from year to year.
4. The Minnesota Center for Farm Financial Management reports that for 509 reporting farms in 2009:
 - The average cost of production was \$14.01 pre cwt.
 - The low 20% in net return had a cost of production of \$17.46.
 - The high 20% in net return had a cost of production of \$11.28.
5. Cost of production affects the supply of milk. It does not directly affect the demand for milk.

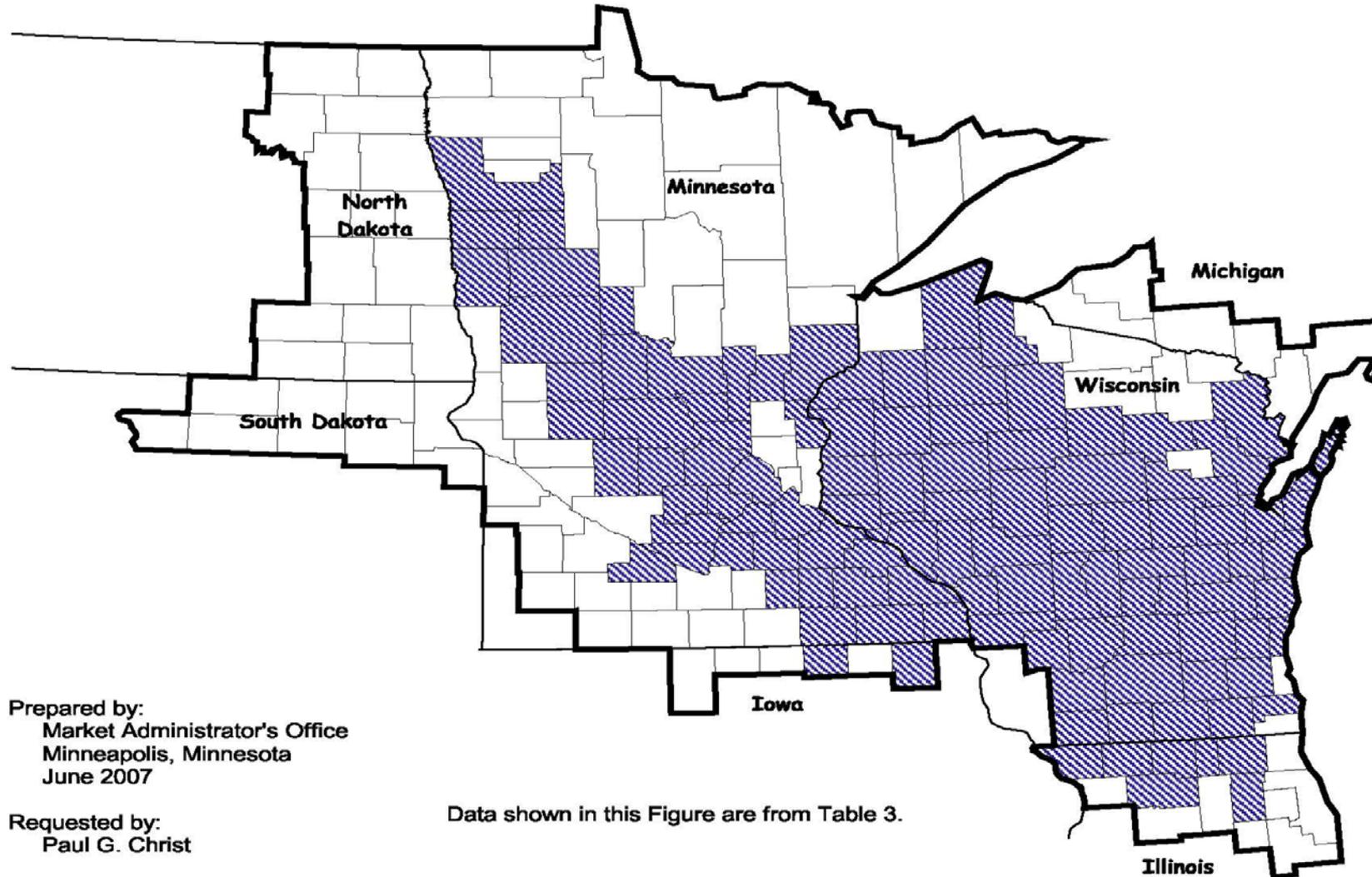
What' s the Best Option?

1. Growing sentiment for returning to a  to set Federal milk order prices.
 - a. Proposed by the Maine Dairy Ind (MA) in 2007.
 - b. Further details need to be worked out
2. A basic issue is how to discover a com

How Much Competition for Milk Exists?

1. In 2007 the MDIA asked the Upper Midwest Federal milk market administrator to assemble data on competition in that market.
2. One measure of competition was the number of buyers of milk direct from farmers in each county.
 - The following shows the counties in the Upper Midwest that had five (5) or more buyers of milk in December 2006.

Figure 3
Upper Midwest Order Marketing Area
Counties with Five or More Milk Buyers
December 2006



Prepared by:
Market Administrator's Office
Minneapolis, Minnesota
June 2007

Requested by:
Paul G. Christ

Data shown in this Figure are from Table 3.

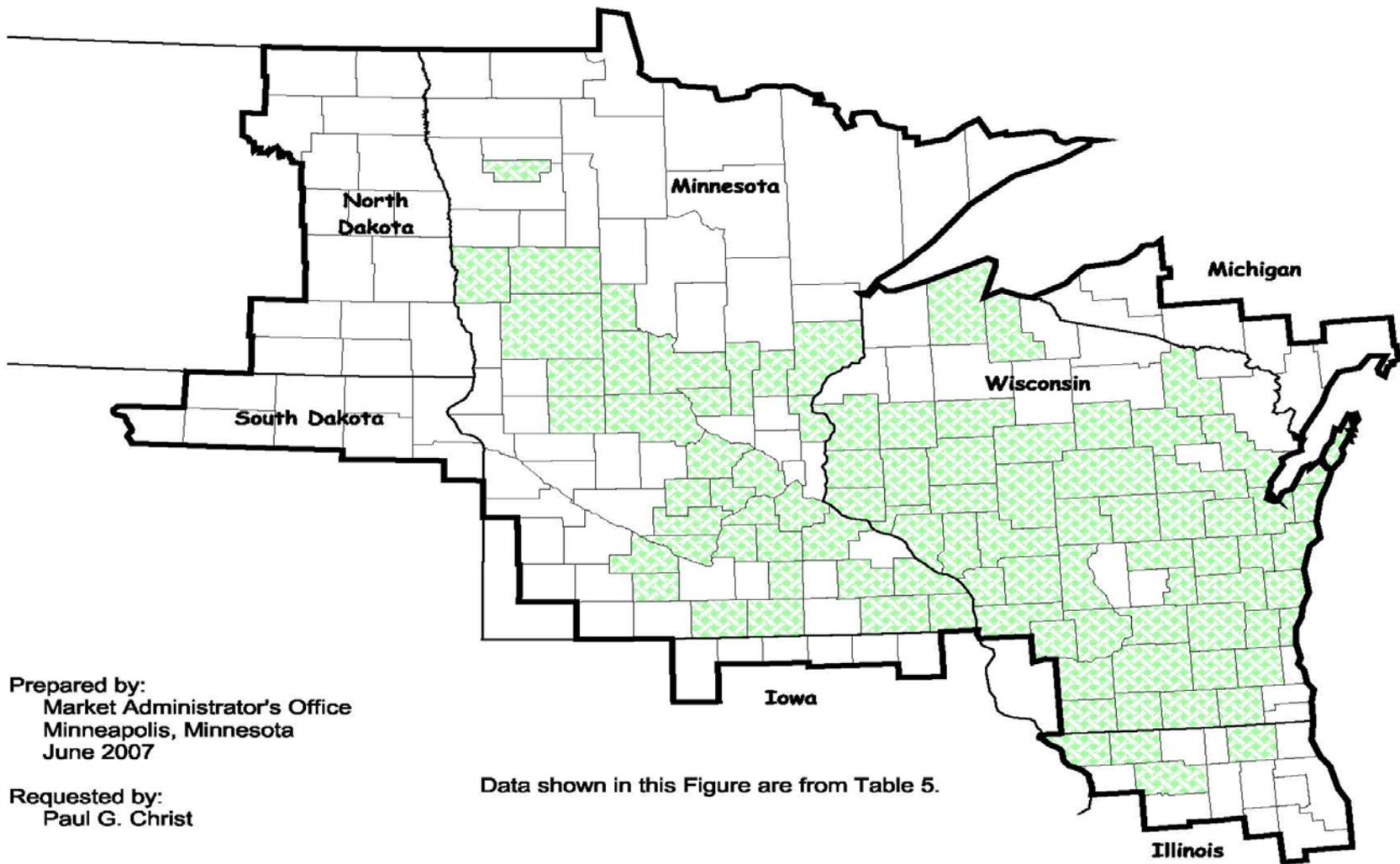
How Much Competition for Milk Exists.

3. The second measure of competition was the so-called Herfindahl Index, which is used by the Department of Justice in anti-trust enforcement.

- The Herfindahl index is calculated by squaring the market shares of each of the buyers in a market, and then adding them up. The effect is to give more importance to big buyers compared to small buyers. A small number, say 0.25, means more competition than a large number such as 0.50.

- The counties in the Upper Midwest that had a Herfindahl index of 0.33 or less in December 2006 are shown on the following slide.

Figure 5
Upper Midwest Order Marketing Area
Counties with a Herfindahl-Hirschman Index of .33 or Less
December 2006



Prepared by:
 Market Administrator's Office
 Minneapolis, Minnesota
 June 2007

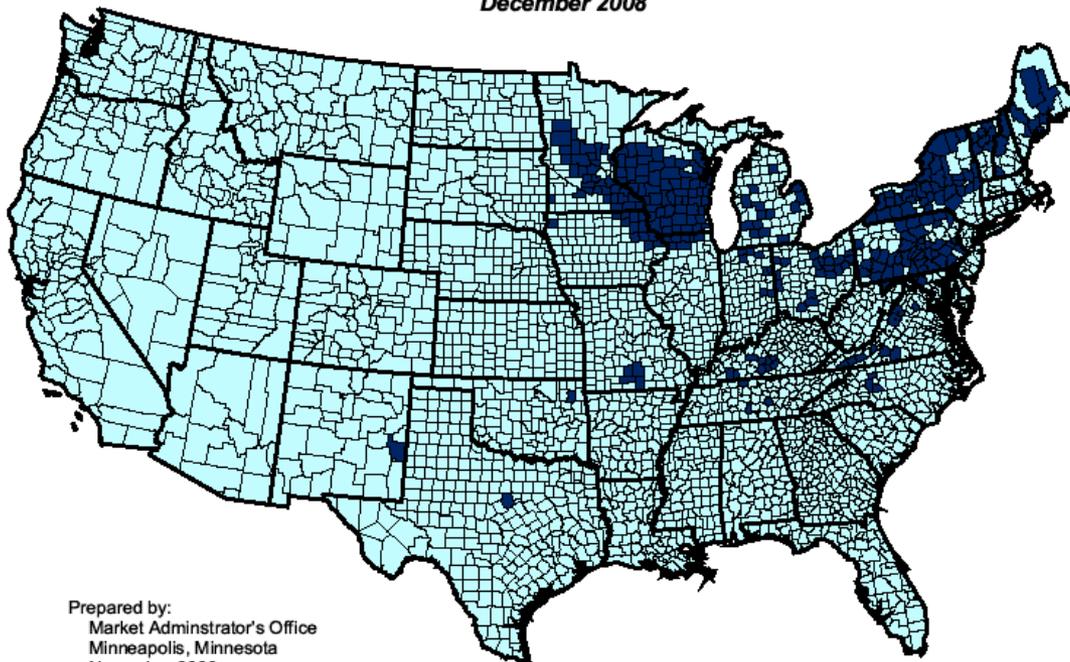
Requested by:
 Paul G. Christ

Data shown in this Figure are from Table 5.

How Much Competition for Milk Exists?

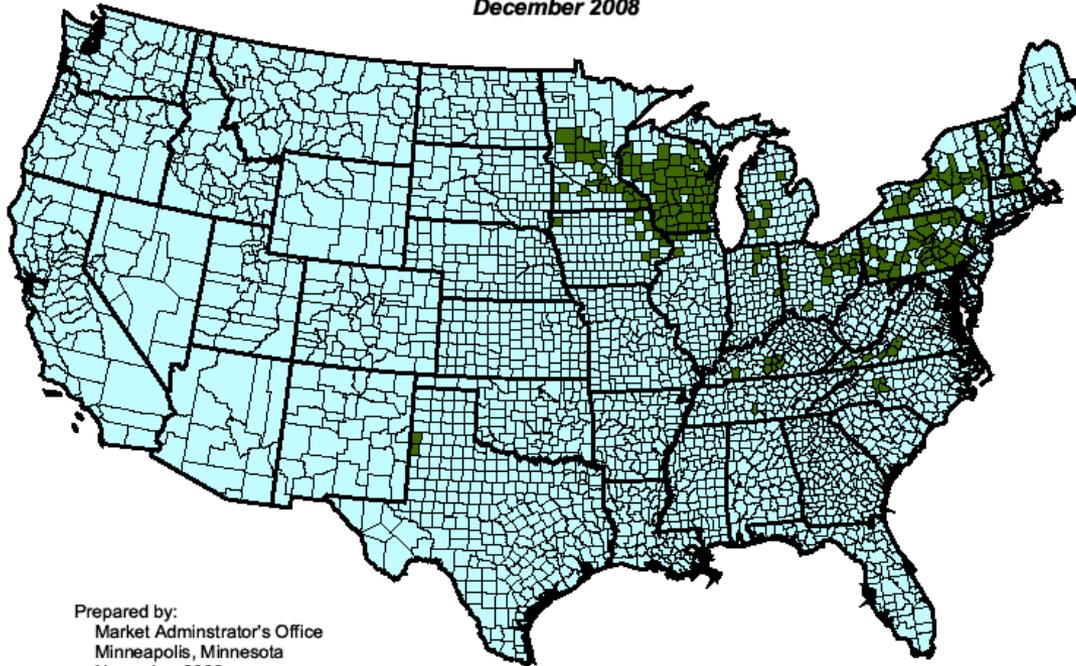
1. Data for the Upper Midwest indicated that there was vigorous competition for milk in most of that region.
2. Questions arose as to whether similar competition also existed in other parts of the country.
3. To get answers, the MDIA asked the USDA Associate Administrator for Dairy Programs to provide data for the entire Federal order system. The work was coordinated by the Upper Midwest market administrator's staff.
4. The results for December 2008 are shown on the following two slides.
5. A complete copy of the USDA report is available as a handout.

Figure 3
Counties with Five or More Paying Handlers
December 2008



Prepared by:
Market Administrator's Office
Minneapolis, Minnesota
November 2009

Figure 5
Counties with a Herfindahl-Hirschman Index of .33 or Less
December 2008



Prepared by:
Market Administrator's Office
Minneapolis, Minnesota
November 2009

How Much Competition for Milk Exists?

1. The two preceding maps show that significant competition for milk exists in the Midwest and in the Northeast.
2. The presence of competition in these areas is reflected by Mail Box Prices in these areas regularly being higher than Federal order minimum prices.
3. Most of the territory in the Federal order system does not exhibit the level of competition reflected in the two preceding maps.

How Much Competition for Milk Exists?

4. The following table shows how much Federal order milk is purchased in the counties with different levels of competition:

3 or more handlers 80.68%

4 or more handlers 74.64%

5 or more handlers 69.50%

Herfindahl of .25 or less 43.07%

Herfindahl of .33 or less 53.79%

Herfindahl of .50 or less 68.48%

How Much Competition For Milk Exists?

5. More than half the milk purchased in the Federal order system is located in the counties highlighted on the two preceding maps.
6. In our opinion that is enough to provide a solid base for developing a competitive price for milk under Federal milk orders.

How Can a Competitive Price Be Constructed?

1. Prices collected in a competitive environment are more likely to accurately represent the market value of milk.
2. To get a “ clean” competitive price that is not distorted by regulated minimum prices, it is necessary to deregulate producer payments in these competitive areas.
3. We suggest that the Federal order system establish two pools in each Federal order.
4. The first pool would only pay out the Producer Price Differential (PPD) to be added to the open-market competitive price paid by buyers in the competitive areas.
5. Buyers of milk would be required to report what they paid for milk, over and above the PPD, just like they reported the Minnesota-Wisconsin Price in the past.

How Can a Competitive Price be Constructed?

6. This difference, reflecting the value of manufacturing milk, would be used to set the Class III (cheese milk) price, and would become the basic formula price (BFP)
7. The second pool would include all milk purchased outside the competitive areas. It would operate exactly as the current Federal order pools operate. The only difference would be that the basic formula price would come from the competitive pools, and not from a complicated product formula price.

Is a Competitive Milk Price Feasible?

1. There is growing interest in competitive milk pricing.
2. The Maine Dairy Industry Association presented a complete plan at a national Federal milk order hearing in July, 2007.
3. The MDIA plan is flexible and can be adapted to most other potential changes to Federal milk orders.

Summary

1. The present dairy product formula method of setting Federal milk order prices has many difficulties.
2. Milk prices established in a competitive environment would more accurately reflect the market value of milk.
3. There is a significant amount of competition for most of the milk purchased under Federal milk orders.
4. It is feasible to deregulate producer prices in competitive areas, with no harm to producers.
5. The open-market competitive prices established in competitive areas would provide a credible basis for Federal milk order prices in less competitive areas.

Summary

6. The MDIA has developed a plan for constructing a competitive milk price, and a method for using it in Federal milk orders.
7. The MDIA will cooperate with other organizations that are seeking to develop a competitive price for milk.

For more Information

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