EX 29

HOARD'S DAIRYMAN
Founded in 1885

Why do "make allowances" matter?

How much producers get credited for making cheese and butter is a key, but controversial, part of our new pricing system.

by Mark Stephenson

IN THE 1960s, there was growing awareness that our industry was becoming "small," small in the sense that, even though federal milk marketing orders had been regulated as isolated markets, dairy products were moving much greater distances outside the orders. Consolidating these small orders (there were 83 at one time) into fewer and larger regions was part of the solution to producer and processor equity in a changing industry. But it became obvious that minimum regulated prices needed to be coordinated across all markets. The important milk for this country was Grade B . . . not eligible for the fluid market or federal order regulation. The largest supply of this "B" milk was in the Upper Midwest.

An excellent idea 40 years ago was that we could observe the competitive buying and selling of this unregulated milk and use that price as the starting point for federal order regulation. That price became known as the Minnesota-Wisconsin (M-W) price. As the Grade B milk supply dwindled, the reliability of the M-W price was called into question as being a good indicator of the market value of milk.

In 1995, the M-W was modified to what we referred to as the BFP or basic formula price. The basis of the BFP still was a survey of Grade B plants, but the prices were updated each month using a product price formula.

Then came implementation of federal order reform this January 1. Grade B milk price surveys were dropped altogether in favor of product price formulas for federally regulated milk.

Product prices used . . .

Here's the idea behind using product price formulas. If we can no longer directly observe a market-determined price, then we need to look at the next step up in the marketing chain (dairy products) to find unregulated buying and selling behavior. These product prices then can be used to determine a value for the milk used to make them.

For example, if we observed that cheese was selling for $1.30 per pound, then 10 pounds of cheese would be worth $13. It takes about 100 pounds of milk to make 10 pounds of cheese, so a first cut at a product price formula might be cheese price times 10. The value of 10 often is referred to as a "yield factor."

However, it costs something to transform 100 pounds of milk into cheese, and that cost should also be accounted for in the formula. This value is called a "make allowance" (what it cost to "make" cheese). Let's just say that it cost $1.50 to make 10 pounds of cheese, so our milk price is now calculated as $1.30 times 10 minus $1.50 which would equal $11.50 per hundredweight.

The actual product price formulas in the final rule are somewhat more complicated than this example. But several important and possibly contentious issues are illustrated by this simple example.

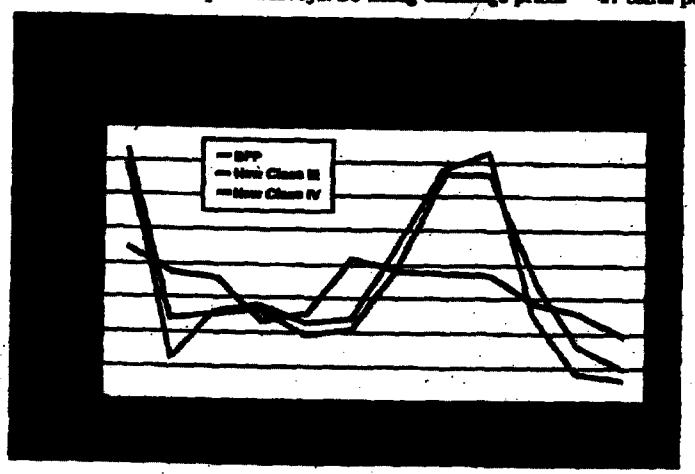
A first issue is what cheese price to use — American style, Italian cheeses, all cheeses, 40-pound blocks, barrels, and so forth. Do you use the cheese price that can be observed on the Chicago Mercantile Exchange, or do you survey plants for contract sale prices?

A second issue is the yield factor. Is it really 10 as a calculation. What did it actually cost to transform milk into cheese?

Changing any of these values changes the calculated price of milk.

USDA chose NASS . . .

Naturally, milk producers would like to see values used in the formulas which would result in the highest possible milk price. The Chicago Merc cheese cash prices have averaged somewhat higher than the NASS (National Agricultural Statistics Service) price surveys. So using exchange prices would yield a higher average milk price. The USDA chose to use NASS survey values over the Mercantile Exchange prices in 1995 when producer groups alleged the possibility of price manipulation on the Green Bay Cheese Exchange.



A higher yield factor also would calculate a higher milk price as would a smaller make allowance. Regulators can tinker with any or all of these factors in the formulas. But the question boils down to what milk price the formulas generate.

As an example, changing the make allowance for cheese by one penny changes minimum blend prices by about 8 cents per hundredweight. This may not sound like enough money to be a major issue, but, nationally, it is more than the $125 million Congress provided to milk producers for disaster relief this year. Small changes in these formulas can have significant impacts.

At the risk of generating many letters to the editor, I suggest that the real danger in regulating minimum prices is to regulate a price that is too high. Processors paying a regulated price which is lower than a market clearing level will not be able to attract enough milk into their plant. Under this situation, over-order premiums are paid to producers as is the case in most orders today.

If processors must pay more than a market clearing price, they will not want to buy as much milk as is available. Farmers then may be left with unsold milk, or their cooperatives will be forced to find outlets for distressed sales of milk to prevent.

The final rule for federal order reform attempted to calculate a historic Class III milk price that would have existed under their new formulas. Not all of the NASS survey data existed for the five-year time period, so an attempt was made to estimate the survey product prices.

Little price impact . . .

USDA's original calculations showed a new Class III price which would have averaged about 47 cents per hundredweight less than the BFP did over that time period. Since the final rule was published, we have NASS data for all months of 1999. Using the actual survey data that is being used, the calculation of the new Class III price during the year just finished would have averaged about 3 cents higher than the BFP actually did, not 47 cents lower (see chart). Some months would have been a bit higher, some lower, but the annual averages were quite similar.

Our current federal budget was signed into law in November 1999 and included congressional changes to the final rule for federal order reform. The most well-known changes were changing the Class I differentials to the 1A option and the continuation of the Northeast dairy compact.

In that bill, Congress also mandated that USDA go back and look at the product price formulas used to generate minimum class prices. Sometime this spring, USDA will hold hearings to consider changes in these formulas, and I suspect that the make allowance levels will be front and center in that debate.

I am well aware that dairy farms are suffering through the lowest prices that we have seen in more than 20 years. During the debate on make allowances, it will be important that we remember that these low prices are the result of market conditions and not the new order reforms. If we try to boost these low prices with our regulatory tools, we could well find ourselves in a situation with a chronic oversupply of milk and the low milk prices that go with overproduction.

I would predict that, as long as we have federal order regulation, we will have product price formulas determining minimum milk prices. It is important that these formulas are "fine-tuned" to generate a fair price for milk. Unfortunately, "fair" has been proven time and time again to be a slippery term and a debatable topic.

The author is an agricultural economist at Cornell University, Ithaca, N.Y.