

Proposals to Promulgate a Federal Milk Marketing Order for California  
Hearing in Clovis, California, October 2015

*Second Statement of John H. Vetne on FMMO policy evolution:  
Pricing Grade A Milk Used to Manufacture Dairy Products*

In my prior statement, I outlined the evolution of orderly marketing concepts applied by USDA to economic regulation under Federal Milk Marketing Orders, and introduced the agency's application of supply and demand pricing under 7 U.S.C. Sec. 608c(18) to individual marketing areas. The discussion highlighted the views of leading dairy experts who have guided the evolution of USDA's milk marketing order policies, conforming to the instruction of the Secretary's Judicial Officer concerning the role such expert views have in marketing order development and review.<sup>1</sup>

In this statement I will review the evolution of surplus milk pricing policies under FMMOs. In yesterday's testimony, Bill Schiek traced much of this history and identified the culmination of agency surplus milk pricing policy as of FMMO reform in 1999, which bears repetition:

The importance of using minimum prices that are market-clearing for milk used to make cheese and butter/nonfat dry milk cannot be overstated. The prices for milk used in these products must reflect supply and demand, and must not exceed a level that would require handlers to pay more for milk than needed to clear the market and make a profit.

64 Fed Reg 16026, 16094 – 95 (April 2, 1999). For "clear the market" pricing, remember that minimum pricing is guided by Section 608c(18), and the focus of that section is on supply and demand for milk and milk products "in the marketing area to which the contemplated" milk order relates.

USDA's post-FMMO reform "clear the market" policy was tested in 2001-02 when manufactured dairy product make allowances were addressed in a hearing. In that proceeding, some producer groups urged USDA to provide more revenue to producers by establishing make allowances at a rate less than the "clear the market and make a profit" objective. The producers observed that many dairy farmers were suffering financial distress and experienced costs of production in excess of milk revenue. The Secretary responded as follows:

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<sup>1</sup> *In re Borden, Inc.*, 46 Agric. Dec. 1315, 1420 (1987). The Judicial Officer further explained by process by which Dairy Programs staff – economists who are "thoroughly familiar with the writings of the agricultural economists in the field" – and OGC attorneys collaborate to produce a decision for final agency approval. *Id.* At 1409 - 10.

There appears to be no logical or economic reason for changing make allowances for processing plants because of a change in the cost of producing milk. If milk is to clear the market, plants must be willing to accept it. Make allowances that decline as a result of increasing milk production costs would squeeze plant margins, and manufacturers will have to choose between not receiving milk, refusing to receive pooled milk, or paying less than order prices to cooperative associations for milk used in manufactured products. None of these outcomes would be in the best long-term interests of dairy farmers, processors, or consumers. Many dairy farmers, facing increased costs of production, would have to find alternative outlets for their milk.

67 Fed Reg. 67905, 67915 (Nov. 7, 2002)

The 1962 Nourse Report<sup>2</sup> explains the classified pricing system, and pricing policies, in Part II of the Report. On pages II-1-6 to 7, the Report explains that national supply and demand drive hard dairy product prices, but market clearing prices for milk must be assessed on a local basis:

Passing from Class I to the lowest price classification, it is to be noted that, if the market price structure is to permit the marketing of the entire supply available to a market, price levels for surplus milk sufficiently remunerative to raw milk buyers to assure handling of such milk should be established for the lowest value classification. From this it follows that the group of products included in this lowest price category (as well as the prices established for this class) depends upon the supply of milk in excess of Class I requirements, the products that the local market processors can manufacture from these excesses, and the prices that can be realized for these products. Historically, order prices have been lowest for milk used for the relatively highly concentrated products, such as butter and the so-called "hard" cheeses. The market prices for these products (which influence the prices producers can charge handlers) are largely determined on the basis of supply and demand forces of national scope) including government outlets under the price support program.

The Nourse Report described product price formulas and competitive milk price formulas for surplus milk pricing. At the end of its discussion on surplus milk pricing, the Nourse Committee cautioned (at pp. II-1-20 to 21) on the need to continuously reassess pricing levels for surplus milk as conditions change from time to time:

While there are various types of formulas that are used in establishing

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<sup>2</sup> Nourse, et al., *Report to the Secretary of Agriculture by the Federal Milk Order Study Committee* (USDA, 1962), <http://dairy.wisc.edu/pubPod/pubs/Nourse.pdf>

surplus prices, no formula so far developed has given the right answer all the time. The final judgment in regard to the surplus price must be based on the developments in the market. A formula may yield fairly satisfactory results for a considerable period of time, and then yield wrong prices which cause undue hardship to some elements in the market, and yield windfalls to others. Accordingly, close and continuous attention must be devoted to surplus pricing not only in relation to internal market developments, but also in respect to relationships between surplus prices in adjacent fluid milk markets and national manufactured dairy products markets.

A decade after the Nourse Report, USDA's Milk Pricing Advisory Committee set the stage for use of product price formulas to fix prices for surplus milk.<sup>3</sup> Part II of the Advisory Committee Report recommended that product price formulas be used to price Grade A milk used to produce butter, powder and cheese in the absence of reliable Grade B survey competitive prices (M-W), because the Grade B milk volume was rapidly dwindling. Following the foundation laid in the Nourse Report, the Advisory Committee explained fundamental principles for surplus milk pricing:

In establishing such a substitute [for the M-W] procedure, the following principles must be recognized: The residual market for manufactured products must clear. To do this, product prices must be flexible. Surplus milk prices must, in turn, closely track revenues from manufactured products or economic distortions will result.<sup>4</sup>

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The prices of the so-called "hard" manufactured products (butter, cheese and nonfat dry milk) are established in a national market.... Handlers producing such products have no opportunity to adjust prices at which they sell such products to assure adequate margins relative to the price for surplus milk established under a milk order. Therefore, the level of surplus price relative to the more or less fixed revenues on manufactured products, as determined by the national market, tends to prescribe the margins a processor realizes on surplus milk. If all the reserve supplies of milk not needed for fluid use are to be marketed in an orderly way and the market cleared, the price for surplus milk must

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<sup>3</sup> USDA, *Milk Pricing Policy and Procedures, Part I, The Milk Pricing Problem*, Report of the Milk Pricing Advisory Committee, March 1972, <http://dairy.wisc.edu/PubPod/Reference/Library/Knutson.etal.1972.pdf>, and USDA, *Milk Pricing Policy and Procedures, Part II, Alternative Pricing Procedures*, Report of the Milk Pricing Advisory Committee, March 1973, <http://dairy.wisc.edu/PubPod/Reference/Library/Knutson.etal.03.1973.pdf>

<sup>4</sup> *Milk Pricing Policy and Procedures, Part II*, p. 12.



be closely related to net revenues from the sale of manufactured products after the deduction of processing costs.<sup>5</sup>

Recognizing the importance of a reasonable make allowance to assure manufacturer margins, and thereby willing market-clearing capacity, the Advisory Committee cautioned that constant review and frequent adjustment would be required.

One of the most troublesome aspects of developing a product price formula is obtaining an adequate basis for arriving at a measure of manufacturing costs or make allowances and keeping them up to date. The Department and the industry cannot shirk this responsibility. The Committee considers and annual review of make allowances, on a verifiable basis, to be necessary in order to keep up with inflation and the effects of technological change as an input to Federal order... decisions.<sup>6</sup>

The guidance provided by the Advisory Committee has largely been followed by USDA in product price formulas adopted in the 1990's (for butter & powder), and in FMMO reform. But review and assessment of make costs, and updating of make allowances, has fallen somewhat short.<sup>7</sup>

The current reference product price formula for Class III and IV milk was fixed for federally-regulated milk markets at the time of FMMO reform in 1999. A significant contribution to the agency's class pricing deliberation was made by the 1996 Cornell U.S. Dairy Sector Simulator,<sup>8</sup> based on 1993 supply and demand conditions, which quantified a price surface<sup>9</sup> for Class I milk.<sup>9</sup> The USDSS report also showed price surfaces for milk used to produce butter, powder and cheese. For

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<sup>5</sup> *Id.* p. 58.

<sup>6</sup> *Id.* p. 14, emphasis in original.

<sup>7</sup> The Advisory Committee also recommended that USDA take a more active role in developing pricing proposals and explaining the market situation in advance of hearing, in greater fairness to participants, following the example set by CDFR. *Id.* p. 77.

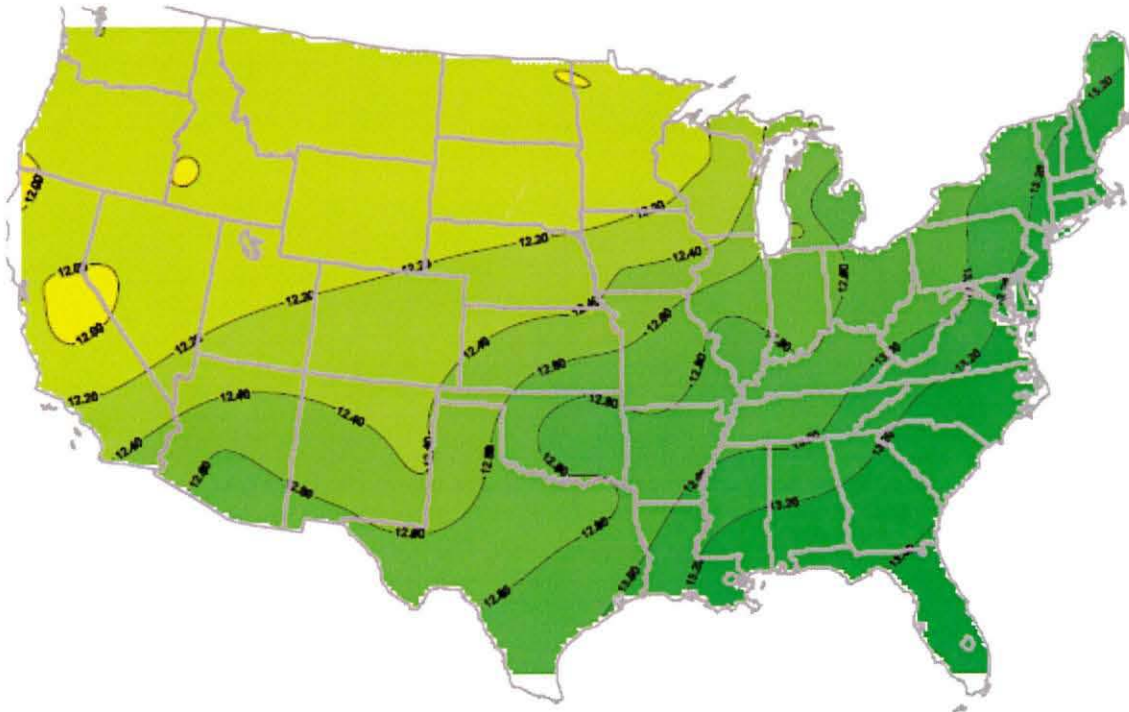
<sup>8</sup> Pratt, James, Andrew Novakovic, Mark Stephenson, Phil Bishop, and Eric Erba, *U.S. Dairy Sector Simulator – A Spatially Disaggregated Model of the U.S. Dairy Industry*, Cornell Agriculture Economics Staff Paper, November 1996, <http://dairy.wisc.edu/pubPod/pubs/SP9606.pdf>

<sup>9</sup> A price surface for fluid milk was observed as early as 1955 in an AMS study entitled "Regulations Affecting the Movement and Merchandizing of Milk," Market Rsch. Rpt. No. 98 (AMS, USDA, June 1955), discussed in Novakovic, Andrew & James Pratt, *Geographic Price Relationships Under Federal Milk Marketing Orders*, Dept. of Agric. Econ., Cornell University, Sept. 1991, at. P. 24.

[http://ageconsearch.umn.edu/bitstream/123110/2/Cornell\\_Dyson\\_rb9108.pdf](http://ageconsearch.umn.edu/bitstream/123110/2/Cornell_Dyson_rb9108.pdf)

powder and butter, the lowest prices on the national surface were in the West and Northwest.

The 1993 NFDM price surface lowest price was in central California:



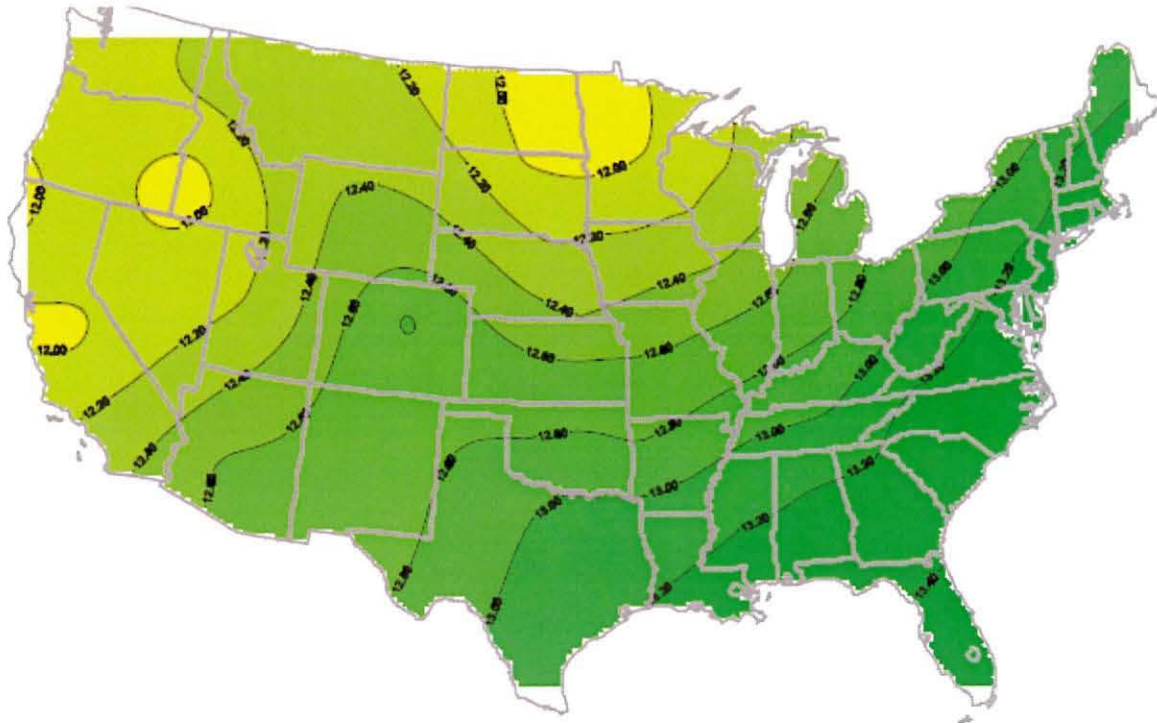
Simulated Value of Standardized Milk at Powder Plants. \$/cwt.  
Based on 1993 Annual Data  
PRELIMINARY

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This generally corresponds with the geographic distribution of 1993 NFDM production as reported by NASS. For 1993, the national midpoint of total US NFDM production – an approximate line where half of the NFDM is produced to the west of the line, and half to the east – was along the eastern border of California and Washington. These two states accounted for 545,055,000 lbs NFDM, nearly 58% of total US NFDM production of 947,117,000 lbs. NASS Dairy Products, Annual Summary 1995, Ex. [128](#), p. 7. The 1993 relationship of California NFDM production to the rest of the United States was similar in 2004 and 2014. NASS Dairy Products, Annual Summaries, 2005 and 2015, Ex. [128](#), pp. 13, 19.

The 1993 USDSS price surface for cheese revealed low price locations in the far ~~upper~~ Upper Midwest, Southern Idaho, and in Central California, as shown on the

following USDSS map:



Simulated Class III Price of Standardized Milk at Cheese Plants. \$/cwt.  
Based on 1993 Annual Data  
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The corresponding geographic distribution of Cheese production, as well as the sub-category of cheddar cheese production in 1993, is shown in NASS Dairy Products. The Western states produced only 23% of the nation's cheese, and 22% of the nation's cheddar cheese in 1993. The geographic midpoint was approximately in the north central areas of NASS reporting regions. Ex. [128](#), pp. 3, 5, 6. NASS dairy products data for 2004 and 2014 reveal that the cheese and cheddar cheese production midpoint is still in the midwest (NASS Central region), even though the production share represented by the West climbed to 43% for all cheese, and 46% for cheddar cheese in 2014. Ex. [128](#), pp. 9-11, 15-17. It logically follows that a average price for cheese, or for cheddar cheese, would essentially be a Midwest price. We do not know, unfortunately, whether the geographic distribution of NDPSR cheddar cheese production, or survey price averages, follow this pattern.

The current list of California cheese plants that contribute to this picture is contained in the CDFA dairy plant list, reproduced on pp. 20-24 of Exhibit 128, and in a CMAB list of cheese plants eligible to use the "Real California" seal, Exhibit 128, pp. 25-43.

Finally, a Census Bureau economic report showing California cheese plants grouped by employee numbers is contained in Exhibit 128, pp. 44-45.



## References

AMS, USDA, Federal Milk Marketing Order Reform documents.

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<http://www.ams.usda.gov/sites/default/files/media/FOR%20Regulatory%20Impact%20Analysis.pdf>

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