3. CLASS I PRICING STRUCTURE

This decision adopts a Class I pricing structure that provides incentives for greater structural efficiencies in the assembly and shipment of milk and dairy products. In conjunction with other reforms discussed in this decision, the adopted Class I price structure provides the necessary changes needed to improve milk pricing in the consolidated markets. The adopted Class I pricing structure results from additional quantitative and qualitative analyses of Option 1A and Option 1B that were presented in the proposed rule issued January 21, 1998 (the PR), consideration of public comments received to these options, and the legislative requirements of the AMAA. The adopted Class I pricing structure utilizes USDSS model results adjusted for all known plant locations and establishes differential levels that will generate sufficient revenue to assure an adequate supply of milk while maintaining equity among handlers in the minimum prices they pay for milk bought from dairy farmers.

Background

Although not required by the 1996 Farm Bill, the legislation provided authorization for the Secretary to review the Class I price structure as part of the consolidation of the orders including the consideration of utilization rates and multiple basing points for developing a pricing system. In any event, the consolidation of orders requires the review of the pricing system because historically, Class I pricing provisions, as well as other Federal order provisions, have been reviewed primarily on an individual market basis. The reform effort provides the opportunity to consider and establish a nationally coordinated Class I pricing surface that uses location adjustments to the differential levels to price milk for fluid use in every county in the United States.

The PR provided an extensive review of 7 options that were developed and considered. After qualitative and/or quantitative analysis, all but Option 1A and Option 1B were preliminarily eliminated for various stated reasons. Nonetheless, the PR invited comments on any of the seven pricing options or any other pricing ideas. Also, the Department indicated a preference for Option 1B for a number of reasons. Nearly all of the public comments received in response to the PR on Class I price structure focused on the relative merits of Option 1A and Option 1B. No persuasive comments were received to cause the Department to further consider the other five options.

The USDSS Model

Option 1A and Option 1B were based to a significant degree on the U.S. Dairy Sector Simulator Model (USDSS). The USDSS was used to evaluate the geographic or “spatial” value of milk and milk components across the U.S. Using 240 supply locations, 334

consumption locations, 622 dairy processing plant locations, 5 product groups, 2 milk components (fat and solids-not-fat) and transportation and distribution costs among all locations, USDSS determines economic efficient location values for milk and milk components. The model initially used data from May and October 1995, and for this decision used updated data from May and October 1997.

The supply and consumption of milk used by the model are aggregated to geographic points -— consumption points and supply points —- to simplify a very complex problem. The production of milk and the consumption of dairy products are fixed at the various supply and consumption points used by the model. Plant locations were restricted to those presently processing products but plant processing locations were not constrained with respect to the volume processed. Processing costs were assumed to be uniform between locations and across plant volumes (no economies of scale). Therefore, the model allowed processing to move among available locations to find the least cost solution in terms of assembly from supply points through distribution to consumption points.

Transportation costs in the model include costs of raw milk assembly, interplant bulk shipment, and the cost of hauling finished products. Transportation costs among regions reflected not only distance traveled, but also differences in wage rates and State highway weight limit restrictions. While assembly costs and interplant bulk shipments were calculated using a linear cost function, the finished product functions were non-linear. In fact, finished product hauling costs (e.g., packaged milk) fell below raw milk assembly and hauling costs on an equivalent unit basis in many cases at distances more than 900 miles. Previous spatial modeling had assumed constantly higher finished product transportation costs versus raw milk assembly and shipping costs for all distances. The updated model results were based on transportation cost analyses, particularly the reduction in distribution costs for finished products resulting in distribution costs for these products on par with bulk milk assembly and hauling costs.

The output from the USDSS model provided information as to optimal processing locations and volumes at those locations, milk assembly, and intermediate and finished product distribution flows. It represented a least cost, or “most efficient” organization of the industry. Importantly for the research, the model provided the marginal values (i.e., the value of one more unit) of milk at each location. These values, technically known as shadow prices, are indicative of values that are consistent with the optimized solution. A shadow price on one unit of milk at any processing location can be interpreted as follows: If the

processor at a particular location had one more unit of milk, the entire pattern of milk assembly, and product transportation could be reorganized in such a way that marketing costs, equal to the shadow price, could be saved. This notion of marginal value is consistent with economic theory on how prices are determined in a competitive market.

The significance of the shadow value in terms of milk price regulation may be stated: If the regulated price, or cost of milk, is arbitrarily set higher than the shadow price at a particular processing location, a lower cost solution could be found by processing more milk at another location. This would imply higher transportation costs for either raw milk assembly, finished product distribution, or both. Such a result clearly leads to a higher cost, less efficient system. It is also contrary to what is generally thought of as the “orderly marketing” of milk which is a fundamental reason for the existence and goal of Federal milk marketing orders.

It should be stressed that the calculated shadow prices of the model output provide information regarding the relationship of the prices among geographic locations. They do not provide guidance regarding the overall level of Class I prices or differential values. That is, the model does not help us understand whether the Class I differential should arrive at a Class I price of $14 in Minneapolis and $15 in New York City, or $15 in Minneapolis and $16 in New York City. However, it does tell us that the resulting Class I price difference between the two locations should be about one dollar.

A positive aspect of the USDSS model is the degree of detail available in the output. This detail is achieved through the careful assembly of spatially disaggregated data. However, it should be remembered that by its construction, the USDSS is a “model” and thus a simplification of a complex dairy industry. That notwithstanding, the USDSS model does provide an objective and quantitative guidepost from which to compare current federal order differentials and in considering possible alternatives.

Several factors were considered in selecting a replacement for the current[1] Class I price structure that served to form the criteria used to examine options. First, a Class I price structure must be considered from a national, as well as a local or regional, perspective. Many comments from industry addressed Class I pricing issues from a local or regional perspective in the

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[1] Any references to the "current" system of Class I prices or the "current" price structure are to be interpreted as those established in or after the final decision based on the 1990 national hearing issued March 5, 1993 (58 FR 12634).

development of options presented in the PR. These comments provided valuable information about particular markets but generally did not consider the feasibility or impact of a local or regional issue on a national basis. While remaining mindful of local and regional concerns, USDA has also evaluated alternative Class I pricing structures from a national perspective, as should be expected, given the national concerns expressed about milk pricing.

Second, a Class I price structure must recognize the location value of milk. Results from the USDSS model confirm that milk has value at location. As described earlier, the model provided shadow prices reflecting the relative values of milk and milk components at geographic locations. While the model shadow prices did not suggest Class I differentials for specific locations, they do provide a means to evaluate price relationships among locations.

Third, a Class I price structure must recognize all uses of milk. The classified pricing system contained in the Federal milk order program values milk for fluid use higher than milk used for soft or hard manufactured products. The higher Class I price encourages all milk to be used first to satisfy Class I needs. At the point where the cost of moving milk from an alternate location for Class I use is equal to the cost to supply milk for manufactured products, demand for manufactured products influences a market's ability to procure milk for Class I needs. Thus, all uses of milk must be considered when evaluating a national Class I pricing structure.

Finally, a Class I price structure must meet the requirements of the AMAA. The broad tenet of the AMAA is to establish and maintain orderly marketing conditions. For the Federal milk order program, this is achieved primarily through classified pricing and pooling. With regard to pricing, it is recognized that the objective of the AMAA is to stabilize the marketplace with minimum prices, not to set market prices. The pricing criterion of the AMAA, § 608c(18), requires prices that are reflective of economic conditions affecting supply and demand for milk and its products. In this regard, consideration was given to whether the proposed prices would generate sufficient revenue for producers necessary to maintain an adequate supply of milk. Equally important, the prices need to provide equity to handlers with regard to raw product costs as required by § 608c(5) of the AMAA.

Evaluation Criteria

In evaluating the final Class I pricing options, nine performance criteria, based upon regulatory objectives and requirements of the AMAA, were again used as they were in the PR. The evaluation criteria are divided into two categories, objective and administrative. The objective criteria are as follows:

1. Ensure an adequate supply of milk for fluid use. Class I price levels need to provide a sufficient price signal to maintain an adequate supply of milk for fluid use. This supply level can be achieved through either the movement of milk to where it is needed, increased production, or some combination of both.

2. Recognize quality (Grade A) value of milk. Grade A milk is required for fluid use. Additional costs of obtaining and maintaining Grade A status need to be reflected in Class I prices.

3. Provide appropriate market signals. A Class I price should send timely signals to the market regarding supply/demand conditions.

4. Recognize value of milk at location. Basic economic theory, validated by actual market observations and University-based research, affirms that milk for Class I use has a different value at different locations. This value needs to be reflected in the Class I price in order for the system to recognize and resemble the market rather than interfere with the market.

5. Facilitate orderly marketing with coordinated system of prices. A system of Class I prices needs to be coordinated on a national level. Appropriate levels of prices will provide alignment both within and among marketing areas. This coordination is necessary for the efficient and orderly marketing of milk.

6. Recognize handler equity with regard to raw product costs. Appropriate levels of Class I prices provide known and visible prices at all locations thereby ensuring that handlers are able to compete for available milk supplies on an equitable basis.

Three administrative criteria are identified and described as follows:

1. Minimize regulatory burden. The Class I price structure should not significantly increase the burden on handlers, particularly small businesses. This would include increased reporting requirements and record keeping, as well as possible increases in administrative assessments should Market Administrators be required to manage a more complex regulatory system.

2. Minimize impact on small businesses. The Class I price should be set at a level that does not disadvantage small businesses in competition with large businesses.

3. Provide long-term viability. The Class I price structure should be expected to operate for an extended time period without major modifications.

The nine evaluation criteria listed above are used to qualitatively evaluate each of the options. Each option is evaluated based on how the option performed compared to the current system, either better than, worse than, or the same as, for each performance criterion. The results of the qualitative

analysis provided a preliminary framework for quantitative analysis using a multi-regional model developed by the Economic Research Service (ERS) of the Department.

As previously indicated, Option 2 - Relative Use Differentials, Option 3A - Flat Differentials, Option 3B - Modified Flat Differentials, Option 4 - Demand-Based Differentials, and Option 5 - Decoupled Baseline Class I Prices with Adjustors, were eliminated from further consideration. They were eliminated for various reasons including failure to adhere to AMAA requirements, the likelihood of creating disorderly marketing conditions, and impacts on small businesses. A discussion of the five eliminated options, including the evaluation against the criteria and/or quantitative analysis were described in detail in the PR.

The Final Options

Three options formed the basis for final consideration and are described below. All options present national Class I pricing structures developed utilizing the USDSS model. The options continue to vary in their reliance and application of the USDSS model but all remain based on economic principles contained within the model. These options include Option 1A, a modified Option 1B, and the adopted Class I pricing structure.

Option 1A: Location-Specific Differentials

Option 1A establishes a $1.60 per hundredweight fixed differential for three surplus zones (Upper Midwest, West, and Southwest) within a nine-zone national price surface, and for the other six zones, an added component that reflects regional differences in the value of fluid and manufacturing milk. This option emphasized current supply and demand conditions with the USDSS model output.

Some minor changes were made to the Option 1A differential levels presented in the PR. The changes only involved adjusting certain county specific differentials to provide for more appropriate price alignment in several counties in the northeast, seven counties in Florida, and one county in North Carolina. Other than these minor changes, Option 1A is the same as published in the PR.

Modified Option 1B: Relative Value-Specific Differentials

This option continues to establish Class I differentials based on a relationship between prices and geographic location as indicated by the USDSS model, but uses more current data. Modifications were made to Option 1B with respect to how adjusted Class I differentials were established for each county in the United States. This modified version of Option 1B continues to establish differential levels by setting and equating the relative value-specific differential of $1.20 per hundredweight in Minneapolis, Minnesota. The Option 1B differentials in the PR

relied on an algorithm to set location adjusted differentials in every county. The modified Option 1B price surface takes into full account all known plant locations as was done in the development of Option 1A. This approach ensures that all plants similarly located would have similar prices.

The Adopted Class I Price Structure

The adopted Class I pricing structure establishes a price surface that also utilizes USDSS model results adjusted for all known plant locations and establishes differential levels that will result in prices that generate sufficient revenue to assure an adequate supply of milk. The differential levels will better maintain equity by raising the level 40 cents per hundredweight higher than the level proposed in Option 1B and in modified Option 1B. The higher differential level reduces the likelihood of class-price inversions, where the Class I prices are below the manufacturing milk prices for the month.

The USDA Multi-Regional Dairy Sector Model

Option 1A, modified Option 1B and the adopted Class I pricing structure were evaluated qualitatively against the evaluation criteria and quantitatively utilizing the USDA multi-regional dairy sector model. This model was developed to answer some very specific questions about possible changes in the dairy sector, particularly changes being considered in milk marketing orders. The main focus of the model's development and use was to quantitatively examine the impacts of the changes under consideration in the classified pricing of milk and dairy products in the milk order system on an order-by-order and regional basis, and for other areas of the country not currently a part of the milk order system.

The multi-regional model establishes a baseline consistent with the USDA official baseline projections for the dairy sector. It assumes 36 regions. These include: 32 Federal Milk Marketing Order areas (including Tennessee Valley that was terminated on October 1, 1997) and four non-Federally regulated areas (California, Other Unregulated Western Counties, Unregulated Northern New York and New England and Other Unregulated Eastern Counties) and projects baseline information through the year 2005. The demarcation between the unregulated Western and Eastern counties follows a line extending north to south on the eastern State borders of North Dakota, South Dakota, Nebraska, Kansas, Oklahoma and Texas.

The model baseline also assumes that the Class III price would be the Basic Formula Price (BFP), the Class II price would be the BFP plus 30 cents, each region's Class I price would be the BFP plus the current Class I differential and the Class III-a price would continue. All other changes to milk order provisions together with the three price surface alternatives are presented

as changes from the baseline over the period of the years 2000 through 2005. Each of the alternatives include the impact of consolidation into 11 regional markets and moving to wholesale product price formulas in setting the class prices.

From its baseline, the model has the ability to quantify the impacts of pricing changes in the consolidated regions and in estimating how the end use of milk may be expected to change with the changes in how the order program will price milk. The model can generate long-term supply, demand, and price projections that are consistent with the USDA official baseline projections.

The model estimates regional milk production based estimates of milk-per-cow and number-of-cows for the 36 defined areas. The milk cow inventory and milk-per-cow estimates for each area is based upon reported state data. Changes in the inventory of cow numbers and output-per-cow for each region are related to regional farm milk prices and feed costs, and past regional net returns to dairy farmers (a measure of profitability). Milk marketings in the region are in direct relationship to milk production in the region.

Once the volume of regional milk marketings is determined, marketings are distributed to seven uses: bottled whole milk, bottled low-fat milk, soft manufactured dairy products, American cheese, other cheese, butter, and nonfat dry milk. Each of the seven uses has a retail demand equation. Generally, the demand for the specific product is a function of per capita income, the retail price or the Consumer Price Index (CPI) of the product, and the price or CPI of a substitute product (e.g. margarine for butter).

Demands for raw milk for use in fluid milk products and soft manufactured dairy products have priority in the model and such demands are filled regionally from the region’s raw milk supply before the national demands of the hard manufactured product markets are met. The Class I and Class II uses of milk in each region are based upon differences in prices and population by region. A CPI for fluid milk and other dairy products are estimated for each region based upon a margin mark-up equation and the region’s Class I and Class II prices. These values are used to estimate regional per capita use, and when multiplied by projected population for each region, determine the amount of milk allocated to Class I and Class II uses.

The sum of each region’s raw milk supply less the milk used in Class I and Class II results in a measure of the national manufacturing milk supply. The model solves for equilibrium in supply and demand by solving for wholesale prices of cheese, butter, and nonfat dry milk that equate the supply and demand in the hard manufactured dairy product markets. The hard manufactured product markets, the Class I markets, the Class II

markets, and the farm level raw milk supply are linked through price equations that relate the changes in wholesale product prices to changes in prices for milk used in Class I, Class II, Class III, Class III-a (or Class IV) and the farm level all-milk price.

A Class III and Class III-a (or Class IV) price is calculated from the model's estimates of wholesale cheese, butter, and nonfat dry milk prices; and these Class III and Class III-a (or Class IV) prices are used to predict Class I and Class II prices. Changes in Class I and Class II prices affect demand for Class I and Class II products and the amount of milk available nationally for cheese, butter, and nonfat dry milk production. Likewise, the amount of milk used in each class in each region and the regional class prices affect the farm level all-milk price and the supply of raw milk in the region and therefore the amount of milk available nationally for cheese, butter, and nonfat dry milk production. The model iterates until an equilibrium is achieved for the year in the wholesale product markets and then advances to the next year.

A brief summary of the quantitative impacts of each alternative price surface is included with the qualitative analysis presented below. A detailed description of the USDA multi-regional dairy model, as well as a complete discussion of the impacts of the pricing alternatives are contained in the Final RIA.

Option 1A: Location-Specific Differentials

Option 1A would establish a nationally coordinated system of location-specific Class I differentials reflecting the relative economic value of milk by location. An important feature of the option is the location adjustments that geographically align minimum Class I milk prices paid by fluid milk processors nationwide regardless of the defined milk marketing area boundaries or order pooling provisions. A basic premise of Option 1A is that the value of milk varies according to location across the United States.

Compared to the modified Option 1B and the adopted Class I price structure, this option tends to most reflect the current Class I pricing surface. Although extremely similar to the current Class I price surface, there are distinct differences. Option 1A would establish a nationally coordinated price surface that uses location adjustments to adjust the price of milk for fluid use for every county of the United States.

Under Option 1A, Class I differentials are the lowest in geographical areas evidencing the largest supplies of milk relative to local/regional fluid milk needs. The differentials become progressively higher as they move from these areas to markets with less production relative to demand for fluid milk.

Nine differential zones provide the basis for establishing the price structure. These zones were established based on results of the USDSS model, knowledge of current supply and demand conditions, and recognition of other marketing conditions such as fluid versus manufacturing markets, urban versus rural areas, and surplus versus deficit markets.

Class I differentials under this option range from a low of $1.60 per hundredweight in the lowest valued zones of the Upper Midwest, Southwest, and West, where there are abundant supplies of milk in excess of fluid milk use, to a high of $4.30 per hundredweight in Florida, where there are deficit supplies of milk for fluid use.

Analysis Based on Evaluation Criteria. Option 1A performs equal to or better than the current Class I system in each of the evaluation criteria. This is largely explained by the adjustments, improvements, and fine-tuning made to the current system of Class I differentials

Option 1A was evaluated against the objective criteria as follows:

1. Ensure an adequate supply of milk for fluid use. Option 1A performs essentially the same as the current price structure in ensuring an adequate supply of milk for fluid use. Option 1A changes current differential levels in some regions to more accurately reflect current milk supply-demand conditions. Option 1A will have minimal impacts on farm level milk prices and should ensure adequate supplies of milk for fluid use.

2. Recognize quality (Grade A) value of milk. Option 1A recognizes the quality value (Grade A) of milk through the addition of a differential that begins at $1.60 per hundredweight in the base zone.

3. Provide appropriate market signals. Option 1A adjusts and refines the existing Class I price structure to provide appropriate market signals. In some geographical areas, Class I differentials would be increased. These changes indicate that current Class I differential levels are not high enough to attract adequate supplies of milk to the applicable fluid milk markets. In certain other areas, Class I differentials would be lowered, indicating that they exceed levels necessary to adequately supply the associated markets with their fluid milk needs.

4. Recognize value of milk at location. The spatial values of milk reflected in Option 1A recognize the value of milk at location more accurately than the current system for two principal considerations. First, in structuring the differentials in Option 1A, the effect of current Class I differential levels on milk supplies, demand, and dairy farmer returns regionally during the past decade were considered. Second, the relative values of milk and milk components at geographic locations throughout the United States from the USDSS model results were considered.

5. Facilitate orderly marketing with coordinated system of prices. Option 1A provides a comprehensive national pricing surface for Class I milk that establishes a value for Class I milk in every county. Thus the price any processor would pay for milk would be the same regardless of which order the processor is regulated under. As such, Option 1A is an improvement over the

current price structure which evolved in a piecemeal fashion. Additionally, the Class I differentials and location adjustments in Option 1A would facilitate more efficient and orderly marketing of milk for fluid use through the nationwide coordination of prices when compared to the current system.

6. Recognize handler equity with regard to raw product costs. Class I differentials proposed under Option 1A are consistent with the inherent economic value of milk at location. The coordination and alignment of prices, based upon cost differences and current marketing conditions, better ensures handlers of equity in competing for available milk supplies.

Option 1A was evaluated against the objective criteria as follows:

1. Minimize regulatory burden. Option 1A would not change the regulatory burden of the Federal order program. Option 1A would not result in increased reporting, record keeping, compliance, or administrative costs to handlers.

2. Minimize impact on small businesses. In regions where more of the actual value of fluid milk would be reflected in the differentials than is currently reflected, small businesses may have a marginal improvement in their relative competitive bargaining position vis-a-vis large businesses. This is based on the concept that large businesses (producers, cooperatives or handlers) are better able to negotiate premiums above minimum order prices due to advantages attained from their size. Overall, this option is not expected to materially impact small businesses differently than the current price structure.

3. Provide long-term viability. To the extent the location adjusted Class I differentials under Option 1A will correct instances of price misalignment and more accurately reflect the economic value of milk by location, the long-term viability of Option 1A is expected to exceed that of the current price structure.

Because the USDSS model only determines the relative value differences for fluid milk between location, it could not be used for determining an appropriate differential level. Option 1A utilizes $1.60 per hundredweight as the minimum differential level. A complete explanation of the factors that developed and explain this differential level was set forth in the PR. In summary of those reasons, the $1.60 per hundredweight differential level is used in Option 1A because it would ensure a sufficient supply of milk for fluid uses in the most surplus regions.

Option 1A will have little impact on small businesses, either producers and processors. In certain situations, it may improve a small business' competitive marketing position as compared to current levels. Because the $1.60 base zone differential includes a competitive factor as discussed previously, more of the actual value of fluid milk will be reflected in the minimum Federal order price. This may decrease the level of the over-order value that must be negotiated between processors and producers. Doing this would provide small businesses with a more equitable competitive position.

Quantitative analysis of Option 1A using the USDA multi-regional model evaluated the various impacts of this pricing option. Overall, the magnitude of price and income changes under Option 1A is relatively small when compared to the baseline. Option 1A results in an 8-cent increase in the average Class I

price for all current Federal orders. Further details of the impact of these Class I price changes, and others, that are based on the USDA model results are available in the final Regulatory Impact Analysis (RIA).

Modified Option 1B--Relative Value-Specific Differentials. Modified Option 1B would also establish a nationally coordinated system of Class I differentials and adjustments that recognizes several low pricing areas. Modified Option 1B more directly applies the USDSS model's optimal solution in developing the Class I price structure.

The modified Option 1B differentials differ from those published in the PR. The differences are explained largely by a more complete consideration of all known plant locations. The Option 1B differential values published in the PR relied on an algorithm to establish differential levels for those counties that were not part of the optimal solution. However, all plant locations need to be considered for setting prices at these locations and prices must be aligned between locations. This has been done in modified Option 1B and results in a "zoned" structure of relative price differences that are aligned.

Modified 1B Differential Level:

As pointed out in the Option 1A discussion, the USDSS model only provided information regarding relative differences in prices between geographic locations and offers no information for determining the level of Class I differentials used in setting Class I prices. The same is true for modified Option 1B. Modified Option 1B relies much more directly on the geographic price relationship results of the USDSS model in defining the structure and relative differences represented in its differential schedule for all locations.

While modified Option 1A establishes a $1.70 Class I differential at Minneapolis, adjusted from a minimum level of $1.60 (the lowest differential level at any location in Option 1A), modified Option 1B sets a Class I differential at Minneapolis at the current level of $1.20 per hundredweight. It is important to note that any modified Option 1B zone could be discussed as the "starting" point differential. This decision only refers to and references Minneapolis at the $1.20 level for illustrative purposes since it provides a degree of continuity in how Option 1B was presented and discussed in the PR.

Because Option 1B was expected to result in a significant change to the industry in both the pricing surface and the level of Class I differentials, it was proposed in the PR in conjunction with three alternative transitional phase-in programs. However, none of the phase-in programs received public support.

The final RIA statement provides the full measure of the USDA multi-regional model analysis of this option. In short, modified Option 1B is rejected because the differential levels it would set would result in minimum prices that would not generate sufficient revenue to assure an adequate milk supply. Additionally, for markets with lower differential levels, there is a greater potential for class-price inversions that would increase the likelihood of disorderly marketing conditions.

The Adopted Class I Price Structure

The adopted Class I pricing structure results from additional quantitative and qualitative analyses of Option 1A and Option 1B, consideration of public comments received to these options, and

the legislative requirements of the AMAA. The adopted Class I pricing structure utilizes USDSS model results adjusted for all known plant locations and establishes differential levels that will generate sufficient revenue to assure an adequate supply of milk and better maintain equity among handlers by raising the level 40 cents per hundredweight higher than the level used in modified Option 1B.

The Class I differential level was set by determining the differential level that results in prices which will generate sufficient revenue to bring forth an adequate supply of milk throughout the Federal order system. As in both Option 1A and modified Option 1B, the adopted Class I pricing structure adds a differential value to the basic formula price in setting Class I milk prices. Additionally, it is set at a level that minimizes the likelihood of class-price inversions, discussed in the BFP section of this decision. The $1.60 Class I differential level (at Minneapolis) achieves these objectives for a nationally coordinated Class I pricing structure.

Increasing the differential level by 40 cents per hundredweight at all locations does diminish the reliance on the marketplace and over-order premiums in establishing market prices inherent in modified Option 1B. However, the adopted Class I pricing structure retains the more efficient pricing structure that offers increased cost savings in the organization of the nation's milk supply and in the transportation of milk and dairy products.

The adopted Class I pricing structure moves the dairy industry into a better organized and aligned pricing system while continuing to assure orderly marketing conditions for producers and handlers. Restructuring the relative-value differential relationships at the level specified will, among other things, generate sufficient revenue in the national system of Federal orders to bring forth an adequate supply of milk. The higher level will also minimize instances of class-price inversions. The location adjusted differentials established for each county are set forth in the Class I Price Structure Maps, and in the General Provisions § 1000.52. The following table sets forth the location adjusted differentials at selected cities.

Comparative Class I Differentials at Selected Cities Under the Adopted Class I Price Structure

City	Current	Adopted	Difference
	Dollars Per Hundredweight		
New York City, NY	3.14	2.50	(0.64)
Charlotte, NC	3.08	2.55	(0.53)
Atlanta, GA	3.08	2.90	(0.18)
Tampa, FL	3.88	4.20	0.32
Cleveland, OH	2.00	2.00	0.00
Kansas City, MO	1.92	1.90	(0.02)
Minneapolis, MN	1.20	1.60	0.40
Chicago, IL	1.40	1.95	0.55

Dallas, TX	3.16	2.10	(1.06)
Salt Lake City, UT	1.90	1.50	(0.40)
Phoenix, AZ	2.52	1.55	(0.97)
Seattle, WA	1.90	1.45	(0.45)

The adopted Class I pricing structure was evaluated against the objective criteria as follows:

1. Ensure an adequate supply of milk for fluid use. The adopted Class I pricing structure establishes lower differentials than current levels in many of the proposed markets. Because the differential level is higher than under modified Option 1B, the adopted Class I pricing structure relies less on the use of over-order premiums as the method to attract adequate milk supplies for fluid purposes. While over-order premiums will remain useful for allowing the market to find the final value of Class I milk, the higher-level differentials of the adopted Class I pricing structure will better serve to ensure that the minimum prices set by the orders will attract an adequate supply of milk for fluid use.

2. Recognize quality (Grade A) value of milk. As with Option 1A and modified Option 1B, the adopted Class I pricing structure similarly recognizes the quality (Grade A) value of milk through the use of a differential added to the basic formula price.

3. Provide appropriate market signals. The adopted Class I pricing structure provides appropriate market signals in all markets even though the adopted Class I pricing structure lowers differentials in some markets. Over-order pricing will likely function in most, if not all markets, even with the higher-level differentials. However, the higher differential level better ensures that the minimum prices established under the orders will generate a sufficient supply of milk and better ensures equitable minimum prices among regulated handlers than does modified Option 1B. Additionally, because class-price inversions are mitigated, more appropriate price signals are provided to the marketplace.

4. Recognize value of milk at location. The adopted Class I pricing structure appropriately recognizes the value of milk at location. It is based on the location value of milk as determined by the May 1997 results of the USDSS model. It also aligns the relative-value differences while adhering to spatial-value differences determined by the model giving full consideration to all plant locations. Thus, in utilizing the model results that determine the most efficient spatial value of milk for fluid use to establish the price surface, the adopted Class I pricing

structure should perform better than the current system.

5. Facilitate orderly marketing with coordinated system of prices. The adopted Class I pricing structure establishes a coordinated system of differentials with appropriate location adjustments. Like the other two options, a comprehensive national pricing surface has been developed that establishes a value for Class I milk in every county. As a result, a processor's regulated price will be the same regardless of the order regulating it.

6. Recognize handler equity with regard to raw product costs. With the 40-cent per hundredweight increase in the differential level, processor equity is better maintained under the adopted Class I pricing structure. With price increases or decreases in some areas, the markets will need to adapt to the new pricing structure. While it is not the intent of the Federal order system to set market prices, the reflection of a larger portion of the price under regulation provided by the adopted Class I pricing structure, better assures handlers a reasonable degree of equity with regard to raw product costs.

The adopted Class I pricing structure was evaluated against the administrative criteria as follows:

1. Minimize regulatory burden. The adopted Class I pricing structure would not change the regulatory burden of the Federal order program in terms of reporting, record keeping, compliance, and administrative costs to handlers.

2. Minimize impact on small businesses. Under the adopted Class I pricing structure, a fuller measure of the Class I value needed to attract adequate milk supplies will come from regulated prices. Reliance on over-order payments negotiated outside the Federal order system is diminished, but continues to be recognized as in either the current system or in Option 1A. As a result, it is likely that small handlers who might have been disadvantaged by the original Option 1B will not be under this modified version.

Federal order Class I prices are mandatory and affect processors in a specific area equally as minimum enforced price levels. Since more of the actual value of Class I milk is represented in regulated prices, the potential for large handlers to have an advantage over small handlers is mitigated in competing for a supply of milk under the adopted Class I pricing structure. Large processors often have advantages related to economies of scale and may be able to temporarily inflate over-order prices they are willing to pay until they have forced smaller businesses out of business who could not afford to pay higher prices.

Additionally, with higher differentials and resulting higher producer blend prices, the balance of market power between producers and processors is better maintained. Producers will not need to negotiate with processors to obtain a better price for

their milk to the extent that would have been expected under modified Option 1B. Small dairy farmers have less production volume, and typically have higher per hundredweight production costs. Hence, small producers who are less able to negotiate for prices that may be higher than the Federal order minimum price will be better served under the adopted Class I pricing structure. When too much reliance is placed on the use of over-order premiums (as in modified Option 1B), it is likely that dairy farmers defined as small businesses would benefit less from the regulation of milk marketing.

Small businesses may be impacted under the adopted Class I pricing structure as adjustments are made in response to the new pricing structure. However, to the extent that small producers may not be able to bargain with processors for over-order premiums to adequately cover their costs, the increased differential level in the adopted Class I pricing structure minimizes this potential outcome. The inability of small processors to compete with large processors at price levels above Federal order minimums is similarly eased.

3. Provide long-term viability. The adopted Class I pricing structure provides for a more efficient pricing structure. This option is an alternative from the current way the Federal order program has approached Class I pricing. Historically the Class I price established under Federal orders represented the minimum value of Class I milk in the marketplace based on the cost of maintaining Grade A milk and associated marketing costs together with the cost of alternative milk supplies. The adopted Class I pricing structure provides the opportunity for increased marketing efficiencies by promoting a more optimal organization in the assembly and distribution of milk products while establishing prices that will assure an adequate milk supply. In this way, it is expected to have long-term viability.

Quantitative analysis of the adopted Class I pricing structure using the USDA multi-regional model evaluated the various impacts of this pricing option. The evaluation assumed the eleven market order consolidation, four classes of milk use, and the BFP replacement presented earlier in this decision. Class I differentials are reduced from current levels in about half of the marketing orders. The reductions range from 4 cents per hundredweight in the Ohio Valley order to as much as $1.18 per hundredweight in the Eastern Colorado order. The Class I differential for the Eastern Ohio-Western Pennsylvania order would be unchanged. For the other markets, the Class I differential is increased, ranging from 8 cents per hundredweight in the Greater Kansas City order, to 57 cents in the Southeastern Florida order.

Under the adopted Class I pricing structure, six current milk orders would have Class I differentials lower than the

differential established at Minneapolis. This gives explicit recognition that these other areas have adequate milk supplies to satisfy Class I demands at lower costs. For areas needing supplemental supplies of milk for fluid use, the Class I differentials are reflective of transportation costs from the closest alternative supply area.

According to the USDA model analysis, the adopted Class I pricing structure differential level would increase order marketings over the six-year analytical period of the years 2000-2005 when compared to the baseline. Raising the differential, in conjunction with shortening the advance pricing notice of Class I prices by 18 days as discussed in the BFP section of this decision, minimizes class-price inversions. The rise in the all-milk price in the first year of implementation is expected to stimulate additional milk production in the milk order system. This additional milk production results primarily from Class I prices being established by using the expected higher Class IV prices in the year 2000. Over the six-year analytical period, the annual all-milk price is expected to drop by about two cents per hundredweight, but the annual average of marketings in the entire milk order system is expected to increase by about 8.3 million pounds when compared to the baseline. This increase in marketings is largely explained by the pooling of milk that was not pooled in recent years because of class-price inversions.

The USDA analytical model suggests that annual cash receipts, or revenue, for producers under the adopted Class I pricing structure will increase in many markets when compared to the baseline. The marketing areas expected to have the largest average annual increases in producer revenue include the following orders: Chicago Regional - $43.1 million, New York-New Jersey - $18.7 million, Iowa - $17.5 million, Southern Michigan - $14.1 million, and Tampa Bay - $12.2 million. Other markets would be expected to have lower estimated annual cash receipts over a six-year analytical period of the years 2000-2005 from the baseline. The marketing orders with the largest reductions include: Texas (-$39.7 million), Middle Atlantic (-$39.5 million), Eastern Colorado (-$11.4 million), Southwest Plains (-$11.3 million) and Central Arizona (-$10.4 million).

The USDA analytical model suggests that as the adopted Class I pricing structure results in lower Class I prices in many markets, the average annual impact on retail prices to the consumer for fluid milk will be about 2 cents per gallon less, on average, over the six-year period of the years 2000-2005 when compared to the baseline. From a national perspective, this translates into consumer savings of about $79 million for fluid milk products annually. Sales of manufactured dairy products over the same time period are expected to decrease somewhat, but

expenditures for these products will be higher.

While only summarized here, the complete USDA multi-regional model analysis of Options 1A, modified Option 1B and the adopted Class I pricing structure are included in the final RIA statement.

Comparison of Option 1A and the Adopted Class I Price Structure

Option 1A and the adopted Class I pricing structure have similarities but rely on differing methods in constructing a nationally coordinated Class I price structure. Both recognize that milk has a location value. Both utilized the USDSS model results to establish the price surface. Both establish Class I prices by adding a fixed differential to the implied value of milk used in manufacturing. Both establish a price surface that assigns a price to every county in the United States and would assure that a price at any particular location will not vary depending upon the marketing order under which the milk is pooled.

Although similar in the above respects, they also differ. First, they differ in the method of determining the level of the Class I differential. Option 1A relies on finding that Class I differentials would be established at a level that more fully reflects the additional value of Class I milk in the most surplus regions. The adopted Class I pricing structure relies on the finding that the national system of milk order needs to result in prices that will generate sufficient revenue to bring forth an adequate milk supply.

Secondly, they differ in how the price surface should be established regardless of the level. Option 1A provides for the alignment of resulting Class I prices by evaluating the cost of alternative supplies based upon the current Class I differential structure. This results in a surface that is smoother and flows primarily from north to south and west to east. However, the adopted Class I pricing structure relies on a cost minimization model to provide for a more efficient organization and structure in milk supply and distribution. Thus, it results in more limited relative price differences and in a price surface that is flatter.

Thirdly, they differ in their reliance on the USDSS model results. Option 1A recognizes the value associated with the model results but relies on knowledge of specific marketing conditions and practices to make adjustments to existing differentials. The adopted Class I pricing structure, on the other hand, relies more directly on the USDSS model results that indicate the optimal spatial values for fluid milk which serve to promote market efficiencies, and implements this structure to encourage market efficiency within the dairy industry.

Public Comments

The majority of comments received in response to the PR dealt with the Class I price structure. In all, 4,217 comments were received on this issue. Of this number, 3,579 comments indicated support for the adoption of Option 1A and 436 comments supported the adoption of Option 1B. Some supportUSDA of both Class I pricing options called for changes in each of the Option's details. No comments were received that supported any sort of transition programs suggested in adopting Option 1B. Some comments, while supporting Option 1B in its general theme, proposed adopting Option 1A initially and phasing in the adoption of Option 1B over an extended time period.

It is clear from the comments received that there is broad-based support for adopting Option 1A. These commenters explained what they thought were and should be the most important goals of the milk marketing order program, the pricing policies and features that it should contain to achieve these goals, and their view of the legislative requirements that must be incorporated into milk orders. Such was similarly expressed in explaining both the support for, and opposition to, Option 1B.

Supporters for Option 1A generally saw it as the best Class I pricing option that would properly reflect the fullest measure of the AMAA's articulated goals and requirements. These supporters expressed the limitations of relying too much on the free market in setting milk prices. For example, supporters of Option 1A indicated that milk marketing orders exist because dairy farmers are at a distinct disadvantage in their marketing relationship with handlers who buy their milk. They cited the characteristics of milk — that it is highly perishable, bulky, is produced daily and must be marketed nearly as often, and is expensive to transport — as making it a unique commodity. Unlike other commodities, grains for example, milk cannot be withheld from the market in the hope for a better price, nor can it be shipped long distances in search of a higher price because transportation costs quickly erode the benefits of a higher price. Dairy farmers don't even know the price they will receive for their milk in advance of having to ship to market, they noted.

Also, supporters of Option 1A were of the opinion that marketing conditions faced by dairy farmers today are fundamentally no different than they were when the order program first began. They point out that even though there are fewer and larger dairy farms with greater milk production, the number of plants at which to sell milk are fewer than when the order program first began. Implicit in this relationship, they said, is the degree of uneven market power that handlers have over producers. One commenter noted that the ratio of dairy farmers to milk plants today has increased threefold since 1960, an indicator of the

growth in the concentration of market power among handlers. Even the prominence of dairy farmer cooperatives over the years has had little significant impact on the relative bargaining power of dairy farmers, noted many commenters. While these organizations have served with varying degrees of success in negotiating for higher milk prices for their members, they said, cooperatives do not and cannot have the ability to significantly impact prices because no entity can control or limit the supply of milk to the marketplace. Because dairy farmers face such a skewed marketing situation, most commenters view milk marketing orders as the only practicable tool to assure farmers receive a fair price for their milk.

Supporters of Option 1A indicated that because of the continuing marketing situation they face, no basis exists for concluding that more emphasis should be placed on a dairy farmer's ability to negotiate prices with handlers. According to these commenters, relying too much on the marketplace would only provide the incentive for producers to needlessly compete with each other to supply the higher-valued fluid market. Those that are successful might receive more for their milk than those who could not, but to this end, there is no guarantee that all handlers would pay the same price for milk. Nor is there a guarantee that handlers would share the higher-valued use of milk equitably with those producers. This, they said, results in disorderly marketing conditions and the pitting of farmer against farmer in unnecessary and destructive price competition. It was these conditions, they note, that led to creation of milk orders and justified the marketwide pooling and minimum pricing provisions contained in milk orders today. Only Option 1A, say its supporters, best establishes the proper value of milk that, together with classified pricing and marketwide pooling, assures the highest degree of equity for both producers and handlers.

Supporters of Option 1A agreed and recognized that it is important to have a Class I pricing structure that is national and more reflective of marketing conditions for milk. Some commenters were of the opinion that the geographic pattern of milk production can be expected to remain as it is today. They noted further that Option 1A gives explicit recognition to more than a single reserve supply area in the country, and that Option 1A would assign the lowest differential in each of these reserve supply areas, what many supporters of Option 1A viewed as significant pricing reform.

Option 1A supporters also thought that the USDSS model served as an excellent tool in developing a Class I price structure. However, they also recognized the limitations of relying too much on this analytical model because it does not bring into consideration all of the other necessary judgements and factors that cannot be included in a model. For example, many commenters

pointed out that while Option 1A used the USDSS model as a guide, it cannot be relied upon for making adjustments to conform with known relationships between and among geographic and actual plant locations. Further, said supporters of Option 1A, the model is static, and cannot estimate the dynamics of changes that may result in supply and demand conditions over time.

In summary, Option 1A supporters indicated Option 1A best assures the continuation of dairy farmers receiving a fair price for their milk. Processors, they also pointed out, would not see a significant change in their ability to compete for a milk supply since most of the value of fluid milk would be contained in the regulated minimum price. They concluded that any changes to milk orders that would diminish these outcomes would be harmful to the dairy industry and to the public interest.

Opponents to Option 1A view it as maintaining too much of the status quo and not addressing the reform needed in Class I pricing. The opponents of Option 1A also view the current Class I pricing structure as seriously flawed. In their view, the current system relies on recognizing the Upper Midwest region as the reserve supply of milk for the country when this is no longer the case. They see Option 1A as largely maintaining this viewpoint.

Opponents to Option 1A and the current Class I pricing structure are of the opinion that today’s differential levels and Option 1A differential levels are too high, or at least higher than necessary to attract adequate milk supplies in many areas. Because Class I differentials are too high, they said, improper economic incentives exist in many areas for increased milk production -- in fact overproduction -- beyond what is needed to meet Class I demand. When this happens, opponents to the current system and Option 1A said, all producers nationally are negatively impacted because the overproduced milk supply drives down prices for milk used in manufactured dairy products which compete in a national market. They noted this is especially injurious to dairy farmers in markets where most of the milk produced is used in manufactured dairy products.

Adding to this, the opponents of the current Class I pricing system and Option 1A are also of the opinion that technology is available today to meet the supplemental milk needs of any milk-deficit area. Not only do they think that higher-than-necessary Class I differentials result in artificially-induced overproduction, they also believe that resulting high Class I prices may be reducing fluid milk consumption by consumers. They are of the opinion that it is more appropriate and efficient to attract milk to meet fluid demands by compensating those who incur the cost of shipping milk from surplus areas rather than paying a high price to local producers in milk-deficit areas to bring forth a sufficient supply of local milk to meet fluid demands.

Supporters of Option 1B indicated support for the more market-oriented theme reflected in this Class I pricing option. These supporters commented that Option 1B will allow milk prices to respond more appropriately to changing supply and demand conditions. Because of this, they said, the milk order program will become more market-oriented. The overall pricing structure offered in Option 1B, they say, flattens the resulting level of Class I prices throughout a larger portion of the country, thereby providing more of a level playing field for producers everywhere.

Supporters of Option 1B view the increased market-oriented theme as the proper direction in which to bring the Class I pricing structure as the milk order program is reformed. Not only is it consistent, in their view, with the reform mandates established by Congress in enacting the 1996 Farm Bill, the movement to a more market-oriented milk order program will provide incentives for private sector innovations that will benefit dairy farmers and consumers.

Supporters of Option 1B take a fundamentally different view than supporters of Option 1A on the appropriate level of the Class I differential. Supporters of Option 1A are of the opinion that Class I differential levels should be set high enough to assure the least amount of price inequity among handlers and should also be at levels high enough to not lower returns to producers. However, the supporters of Option 1B think that Class I differential levels should be set at minimum levels that will allow the effective price for milk to be much more determined by the marketplace. In this way, they said, milk production and prices would respond more effectively to changing supply and demand conditions. By taking this approach, they say, Option 1B Class I differential levels will provide a sufficient degree of the structure needed for producers and handlers, while reducing market distortions that result from regulation-induced prices that discriminate against producers, especially in the Upper Midwest region.

As mentioned above, supporters of Option 1B called for certain modifications. The most significant change included the lowering of the Class I differential level for Minneapolis, Minnesota. These commenters offered a $1.08 per hundredweight Class I differential level for this location. They based this recommendation on their own study and survey of prevailing conditions in the Minneapolis area. This proposal is consistent with their view that Class I differential levels should be set at minimum levels. This level included, they said, premiums above the Upper Midwest’s order blend price, quantity and quality premiums, and hauling subsidies. From this level, all other differential levels should be set and adjusted.

These commenters also cited the USDSS model’s limitation in

determining the proper alignment of Class I differential levels, a similar criticism voiced by Option 1A supporters. These commenters are also of the opinion that, due to more than 60 years of Federal regulation, the relative value differences implied in the model results were too much like existing value differences than would be the case in an unregulated market. They indicated that the USDSS model's optimal solution values should be used conservatively as maximums in setting relative geographic differences to the Class I pricing structure. Some commenters suggested that because the model establishes geographic values for all milk uses, a bias results toward higher Class I values relative to manufacturing values in many markets.

Opponents to Option 1B did not the idea of making the milk order program more market-oriented by reducing Class I differentials in setting Class I milk prices. If this is done, say Option 1B opponents, a cascading series of events will result that seem not only contrary to why marketing orders exist, but will return the dairy industry to the marketing situations that led to their establishment. Most important, they said, Option 1B would result in, and in fact calls for, the altering of current supply and demand conditions for milk. These commenters are of the opinion that the Department should not act to cause changes in either prices or marketing conditions. Additionally, they are also of the opinion that it was not the intent of Congress to have milk order reform result in either an increase or decrease in returns to dairy farmers.

Opponents of Option 1B were of the opinion that too much reliance was placed on directly applying the USDSS model results as the Class I pricing structure, and that inappropriate reliance was also placed on the role of over-order premiums in achieving a more market-oriented pricing plan for the milk order program. Opponents argued that today's over-order premiums are directly tied to the differential levels and the alignment of Class I prices established under the existing orders. Additionally noted, current and consolidated markets have, and will continue to have, different circumstances that will disproportionately affect the ability of producers to negotiate over-order premiums, especially in those markets where Class I differentials are lowered most from current levels.

Because Option 1B calls for reductions from current differential levels nearly everywhere, they observed, less of a minimum order price is assured to producers. In those markets where minimum order Class I prices are reduced the most, a greater burden is placed on producers and handlers in negotiating actual prices relative to those orders where price levels are not as affected, they said. In other words, noted one commenter, producers in milk-deficit areas would have Class I differentials

reduced the most and would be required to be much more market-oriented than producers in milk-surplus area where the differential level is maintained or increased. One commenter noted, that once over-order premiums are established, they can easily collapse because no one has the ability to control or limit milk production or the flow of milk to market. Very small additional volumes of milk to a market can destroy over-order premiums, this commenter added. On the producer side of relying too much on over-order premiums, they said, prices received would be much less equitably shared and uniform, and would tend to force dairy farmers to engage in ruinous price competition in seeking Class I outlets. On the handler side, they noted, order prices will not be high enough to bring forth that mix of local and distant milk supplies to meet Class I needs. Related to this, some commenters noted that the relative differences in prices that would be set under Option 1B would not provide enough of a price difference to cause milk to move from surplus to deficit areas as would be provided in Option 1A. Relying too much on over-order premiums will benefit large handlers to the competitive disadvantage of small handlers, they said. Because actual milk prices paid by handlers would increasingly be determined outside of the order's minimum pricing provisions, they concluded, handlers would be much less assured of the price their competitors are paying for milk.

Conclusion

Milk is a unique agricultural commodity and faces unique marketing circumstances. It is highly perishable, is produced daily and therefore needs to be marketed in a very committed and continuous production-and-marketing cycle. These characteristics, together with the fact that there are many more dairy farmers than milk buyers, presents the opportunity for marketing problems to occur that can be disruptive and destructive to dairy farmers. This sort of marketing situation places producers at a marketing disadvantage relative to handlers, and without some government involvement, equitable terms of trade between these two entities can be difficult to achieve. These unique features of milk and the marketing situation faced by dairy farmers were noted in public comments and are reflected in the legislation authorizing milk marketing orders. Milk marketing orders, using the tools of classified pricing and marketwide pooling, can significantly mitigate the undesirable effects of this marketing situation and still satisfy the public interest by having an adequate supply of milk at reasonable prices.

As noted in public comments, the structure of today's dairy industry, characterized by many dairy farmers and relatively few buyers, is basically the same as it was when the milk order program first began. No dairy farmer, dairy farmer cooperative or

bargaining organization can effectively serve to either control milk production or limit the supply of milk to the marketplace to achieve a measure of reasonable price certainty. This can, from time-to-time, be achieved but such instances are generally short-lived and cannot be relied upon for serving the public's interest in having a sustainable, stable and reliable milk supply at reasonable prices.

It is clear from the many public comments received that dairy farmers are largely content with the current way the Federal milk order program has approached Class I milk pricing, both in its structure and the degree to which it is has returned equitable prices to producers and handlers. But some changes are needed to assure that this program remains viable to serve the needs of the dairy industry and the public well into the 21st century.

The need to reform the milk order program is clearly and uniformly recognized by industry participants and the public. To this end, most producers and handler entities are of the opinion that the reform effort should result in limited change in the prices that are established under the orders, and that any changes to the system be governed by a minimum of change in the prices and the terms of trade between producers and handlers. Other producer and handler entities are of the opinion that the "traditional" methods of Class I milk pricing are seriously flawed, resulting in a program that has become viewed as economically discriminatory to dairy farmers in certain regions of the country and is institutionally resistant to change. The public too, expects that the program should be operated in a manner that will provide and promote efficiency and offer the potential for a less expensive milk supply.

It is the Class I pricing structure that provides additional revenue above the basic value for milk to producers. Because of this, Class I pricing is often viewed as the cornerstone of the milk order program's pricing policy. This is so because the Class I fluid use of milk commands the highest-valued use in the marketplace and is the preferred outlet for milk by producers. It is also this use of milk that has the greatest effect on determining the location value of all milk and in determining the differences in blend prices that are received by producers.

Because milk value varies by location, it is appropriate, in using a classified pricing plan, to establish Class I prices that reflect these location value differences. Supporters of Option 1A and Option 1B agree this is best accomplished with a system of Class I differentials that properly links and aligns milk value. In evaluating how best to accomplish this, it is also important to recognize the significant changes that have taken place within the dairy industry since the full measure of Class I pricing was last undertaken at a 43-day national hearing in 1990.

Today, and as evidenced in the hearing record of 1990, there was general satisfaction with the way Class I milk pricing was developed and employed in a system of orders that had evolved over nearly 60 years. The record of that hearing evidenced that technological and structural changes were underway, but the record did not contain sufficient evidence for changes at that time. The Upper Midwest region of the country can no longer be considered the single reserve supply of milk that the country can rely upon for a supply of milk to meet fluid needs in deficit areas. In fact, the reform effort has clearly revealed that there are several reserve supply areas, and the Class I pricing structure changes adopted are reflective of this change. Other issues -- technological factors, improved assembly and distribution systems allowing for sales competition of ever-larger geographic areas, the growing importance of milk value based on the value of its components -- all speak to the need for reforming the Federal order system.

The PR preliminarily narrowed the Class I pricing structure to two options. Both have similarities and differences that have been discussed in detail. The adopted Class I pricing structure will work in conjunction with other reforms to milk order provisions, especially the more transparent product price formulas and the reduced amount of advance notice for Class I and Class II prices. Taken as a whole, the package of reforms retain the features that are desired and needed to achieve the goals of the AMAA articulated by Option 1A supporters while also providing the appropriate changes needed to obtain greater economic efficiency and equity - an objective voiced by supporters of Option 1B. The adopted class I pricing structure will establish Class I milk prices that will result in a sufficient supply of milk for the national system of reformed and consolidated milk orders.

The adopted Class I pricing structure recognizes and addresses the concerns of Option 1A supporters in their view of the limitations of relying on the marketplace in establishing milk prices to producers that are equitable and reasonable given the marketing situation they face. Similarly, the adopted Class I pricing structure recognizes that handlers will be assured a higher degree of minimum price equity. As importantly, the adopted Class I pricing structure provides the necessary structural reform needed in the dairy industry. The adopted structure provides the incentives necessary for increased efficiency in the organization and distribution of the milk supply and dairy products that is not offered by the price structure of Option 1A.

As discussed earlier, it is important and appropriate that the Class I price structure recognize all uses of milk. The classified pricing system of the Federal milk order program will

continue to value fluid milk in the highest-priced class. The higher-priced classification encourages all milk to first satisfy Class I needs and the adopted Class I pricing structure accomplishes this. Additionally, it continues to consider the cost of moving milk from an alternate location for Class I use, a consideration important to both Option 1A and Option 1B supporters. This is reflected in its aligned structure, recognizing that in supplying milk for manufactured products, demand for manufactured products influences a market's ability to procure milk for Class I needs. In this way, the adopted Class I pricing structure appropriately considers all uses of milk as a national Class I pricing structure.

Finally, the adopted Class I pricing structure meets the requirements of the AMAA. The broad tenet of the AMAA is to establish and maintain marketing stability and orderly marketing conditions for milk. The Federal milk order program will continue to achieve these goals primarily through classified pricing and marketwide pooling. As to pricing requirements, the AMAA objective to stabilize the marketplace with minimum prices and not set market prices is also achieved. As a national Class I pricing structure, it specifically addresses, and adequately sets, appropriate Class I differential levels that will result in milk prices that are high enough to generate sufficient revenue for producers so that an adequate supply of milk can be maintained while continuing to provide equity to handlers.

Class I Price Structure Maps - [west b&w gif, central b&w gif, east b&w gif,color PDF]