

UNITED STATES DEPARTMENT OF AGRICULTURE

Agricultural Marketing Service

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[Docket No. AO-14-A69, et al.; DA-00-03]

Class III and Class IV Milk Pricing Formulas

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**Post-Hearing Brief of the
MIDWEST DAIRY COALITION**

Presented by



Steven D. Etkin

**Coalition Representative
4502 Highland Green Court
Alexandria, VA. 22312
Phone: 703-354-3303
Fax: 703-354-3336**

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INTRODUCTION

In response to the USDA "Invitation to Submit Proposals- Class III and IV Prices," dated January 31, 2000, the Midwest Dairy Coalition submitted a proposal regarding the relationship between Class III and IV prices, and the Class I mover. Family Dairies USA submitted a similar proposal. The two proposals were summarized and combined by AMS, and listed in the Notice of Hearing as Proposal Number 30.

During the hearing, Mr. Gary Gran presented testimony in support of Proposal Number 30, on behalf of the Midwest Dairy Coalition and Family Dairies USA. In Mr. Gran's testimony, he clarified and amplified upon the brief proposal description provided in the Notice of Hearing.

In this brief, we will elaborate upon the arguments made in support of Proposal Number 30, and respond to matters raised in opposition.

ARGUMENTS IN FAVOR OF PROPOSAL

Proposal Number 30 recommends that the existing mover, the higher of the advanced Class III or advanced Class IV price, be changed to a weighted average of the advanced Class III and advanced Class IV prices. The weighting should be based on the portion of manufacturing milk used for Class III and Class IV during the previous year.

As Mr. Gran argued in his testimony, USDA should include this recommendation as part of its final rule for the following reasons:

Using the higher of the advanced Class III or IV as the Class I mover is sending market signals that are inconsistent with supply and demand.

Using the significantly higher advanced Class IV price as the Class I mover under the new federal order rules is sending market signals that are inconsistent with current market conditions. This is contrary to market-oriented dairy policy, and warrants immediate correction.

Current market conditions demonstrate an excess supply of milk. Producer milk prices during the first half of 2000 have been at 1978 levels. Milk production has far exceeded commercial disappearance.

The Commodity Credit Corporation has been purchasing both nonfat dry milk and cheese under the price support program. The Class III price has been below the \$9.90 per hundredweight support price since February of this year.

The Class IV price has been substantially above the support price because butter has been substantially above the support price (\$1.20 to \$1.30 per pound versus \$0.65 per pound price support). Butter prices are above the support price because butter is in relatively short supply.

However, Class IV dairy products (butter and nonfat dry milk) represent only about 10 percent of the federal order milk supply.

Although milk prices are depressed, using the significantly higher advanced Class IV price as the Class I mover has meant higher milk prices of \$1 to \$2 per hundredweight to producers in markets with relatively high Class I utilization and Class I differentials. Due in large part to this non-responsive pricing formula, dairy producers in primarily manufacturing-use markets are experiencing considerably lower milk prices, relative to their counterparts in high Class I utilization markets. Prices in manufacturing-use markets have been near the Class III price, which has been below \$9.55 per hundredweight since February of 2000.

Using the higher of the advanced Class IV or advanced Class III price as the Class I mover sends the "wrong" production signals to producers in the relatively high Class I utilization markets. Reduced milk production is necessary to strengthen cheese prices and overall producer milk prices.

Using the higher of the advanced Class III or IV milk prices as the Class I mover is contributing to disorderly marketing.

All else equal, higher Class I differentials in higher Class I utilization markets attract milk from markets with lower differentials and lower Class I utilization. However, using the substantially higher advanced Class IV price as the Class I mover has significantly added to this incentive to move milk and has resulted in unusual pooling arrangements.

Cheese plants in the Upper Midwest Order are pooling under the Mideast and Central Orders so as to receive a higher pool draw. The higher pool draw enables these cheese plants to pay higher producer prices and attract dairy producers away from other milk plants.

Recently released pool data for Federal Orders 32 and 30 clearly illustrate this concern. For example, in January of 2000, the amount of producer milk pooled on the Central Order (32) was 1,103,361,783 pounds. In May of 2000, the amount of producer milk pooled on the Central Order jumped by about 324.5 million pounds, to a volume of 1,427,867,912 pounds. During that same time period, the amount of producer milk pooled on the Upper Midwest Order (30) dropped about 347.7 million pounds, from 2,432,631,877 pounds pooled in January of 2000 to 2,084,936,796 pounds pooled in May of 2000.

It is no mere coincidence that the reduction in volume of milk pooled on the Upper Midwest Order from January to May of 2000 is so similar to the increase in the volume of milk pooled on the Central Order during that same time frame. The new Class I mover has contributed significantly to these unusual, though predictable, pooling arrangements.

Proposal Number 30 would realign the Class III and IV pricing formulas to ensure that federal orders are internally consistent in adhering to fundamental supply and demand factors inherent in the market place.

The fundamental and over-riding purpose of the federal milk marketing order program is to establish minimum prices for various classes of milk and to allow producers to share in the proceeds so as to provide producers with adequate prices and consumers with adequate supplies of fluid milk, as required under section 608(c)(3) of the Agricultural Marketing Adjustment Act of 1937, as amended.

The orders must also promote orderly marketing conditions by ensuring that order prices and provisions do not cause unnecessary and uneconomic milk movements or inequities between competing handlers.

The Secretary must consider the relevant supply and demand factors in making final decisions affecting federal milk marketing orders. In historical proceedings, the Secretary has relied on the former Basic Formula Price to be the gauge of the national supply of and demand for milk. In the informal rulemaking to establish the current Class III and IV price formulas, a similar rationale was followed. However, Class I prices, now and in the past, have been the gauge to adjust supply and demand factors for fluid milk relevant to each market.

Since the 1960s, the dairy industry has used a Class I mover that is tied to market-clearing prices. The Minnesota-Wisconsin Price Series and the Basic Formula Price both used a weighted average milk value for butter, milk powder and cheese. However, with the new Class I mover that has been in effect since January 1, 2000, this important connection to market-clearing prices has been severed. For the first six months of this year, only butter has cleared above support price level, and nonfat dry milk and cheese prices have been near or below support. To allow butter alone to drive Class I prices ignores the predominant value for manufacturing milk, and leads to a *de facto* decoupling between Class I prices and the value of manufactured milk.

Proposal Number 30 would reestablish the important connection between Class I prices and market-clearing price levels, by using a weighted average of Class III and IV milk values in determining the monthly Class I mover. (Table 5 from Exhibit 42, comparing the current Class I mover and the weighted average Class I mover, has been updated with new monthly data and resubmitted at the end of this brief.)

Proposal Number 30 will maintain the objective of avoiding a negative producer price differential.

One of the original justifications for using the higher of the advanced Class III or advanced Class IV as a mover of Class I was to reduce the probability of a negative producer price differential occurring. Proposal Number 30, using a weighted average advanced mover to announce the Class I price on or before the 25th of the prior month, still closely ties the Class I price to current manufacturing milk values and reduces the probability of a negative producer price differential occurring, relative to the Class I mover in place prior to January 1, 2000.

RESPONSE TO OBJECTIONS RAISED TO PROPOSAL NUMBER 30

The objections raised to Proposal Number 30 during the hearing bore no relation to the fundamental justifications for the proposal, as presented in Mr. Gran's testimony. Instead, the only two objections raised related to:

- 1) concerns that the proposal was out of the scope of the hearing; and,
- 2) concerns about the possible effects of the proposal on Class I prices.

This brief attempts to respond to both of these objections:

Proposal Number 30 submitted by the Midwest Dairy Coalition is relevant to the matter of Class III and IV milk pricing formulas, and is clearly within the scope of the hearing.

The Notice of Hearing included Proposal Number 30 and is evidence that the proposal is within the scope of the hearing.

Administrative Law Judge James W. Hunt over-ruled objections to Proposal Number 30, because it clearly was in the scope of the hearing. [Hearing Transcript (uncorrected), page 1463, line 21-25; page 1464, line 1-5]

As the hearing notice clearly recognized, Class I prices are directly tied to Class III and IV milk prices through a complex formula of advanced pricing and the addition of Class I differentials in each respective marketing area.

In the Preliminary Analysis section of the Notice of Hearing (page 5), USDA clearly states "while the proposals seek to amend the product pricing formulas used to price milk regulated under Federal milk marketing orders and classified as either Class III or Class IV milk, these product price formulas also would affect the prices of milk regulated as Class I or Class II."

Any changes to the Class III or IV price formulas translate directly into changes in the advanced Class III or IV prices, the higher of which also becomes the Class I mover. Thus Class I prices also change directly due to changes to the Class III or IV price formulas. The Secretary must consider the resulting changes to Class I as relevant supply and demand factors that must be balanced in making the final decision.

While Proposal Number 30 would affect minimum Class I prices under the federal milk marketing order system, actual Class I prices will be governed by actual supply and demand conditions.

Proposal Number 30, as clarified and amplified by Mr. Gran's testimony and Exhibit Number 42, would affect minimum Class I prices under the federal milk marketing order system. However, actual Class I prices would be governed by actual supply and demand conditions. If supply and

demand conditions are brought more into balance, as is one of the objectives of Proposal Number 30, minimum federal order Class I prices may have little relevance to actual Class I prices, which would be determined through over-order pricing. However, if minimum Class I prices are set above market-clearing levels, supply and demand conditions are superceded and not permitted to play a role in establishing actual Class I prices.

Class I differentials should be sufficient to provide adequate supplies of fluid milk, without the use of an additional price-enhancing Class I mover as the base.

The Class I differentials that came into effect under the federal milk marketing order system on January 1, 2000 are significantly higher than the Class I differentials that were designated by the Secretary in the Final Decision document published on April 2, 1999 (DA- 97- 12). In spite of the fact that the Secretary determined that the lower Class I differentials in the Final Decision document were sufficient to provide adequate supplies of fluid milk around the nation, Congress dictated the use of higher differentials. Therefore there is no need to also be providing a higher base, in the form of the "higher of" Class I mover, in addition to these higher, congressionally mandated Class I differentials. The combination of the higher Class I differentials and the higher Class I mover only leads to the type of Class I price distortions that the Secretary was originally trying to rectify through the federal order reform process.

Proposal Number 30 has no effect on Class I differentials. Class I prices are affected only because changes in Class III and IV price formulas directly affect Class I prices through the advanced Class III and IV price formulas.

CONCLUSION

There is a direct relationship between Class III and IV price formulas and the Class I mover. It is impossible to adjust one part of the dairy product formula equation, without affecting prices and quantities of other dairy products.

In this context, Proposal Number 30, as clarified and amplified in Mr. Gran's testimony, seeks to bring greater market orientation to the pricing relationship between Class III and IV milk and Class I milk. Evidence was provided in the hearing (Mr. Gran's testimony, Dr. Cropp's testimony, and Exhibit No. 42) showing that the existing Class I mover is inconsistent with supply and demand conditions, and is leading to disorderly marketing. While the extent of these effects was unforeseen by USDA and others, the evidence is now clear on that matter.

Unless a correction is made to modify the Class I mover to send dairy producers in all regions the appropriate market signals, the low milk prices we are currently experiencing will be unnecessarily prolonged.

On behalf of the Midwest Dairy Coalition, I urge the Secretary to include Proposal Number 30, as described in Mr. Gran's testimony, in the final rule on this matter.

Table 5: Current Class I Base (@ 3.5% BF) Compared with Weighted Class I Base*

