

February 1, 2021

MEMORANDUM

TO: Michael Dykes, IDFA
FR: Jim Mulhern, NMPF
RE: Adjusting the Class I Mover

The tremendous volatility in milk prices experienced because of the COVID-19 pandemic during the past year, and the resultant unprecedented spread between Class III and IV prices, has upended the milk classification pricing system and exposed an asymmetrical risk to dairy producers resulting from the 2018 farm bill provision on pricing Class I milk.

This situation has led to extensive discussions in the dairy producer and cooperative community on the need for adjustments to the current Class I mover that restore better balance between producers and handlers on pricing Class I milk. As a result of those deliberations, NMPF is supportive of adjustments to the mover and is seeking producer-processor consensus on needed changes. This brief paper outlines NMPF's proposal to adjust the mover under the provisions of the 2018 farm bill allowing for adjustment by a national FMMO hearing at any point two years after the effective date of the change (i.e., after May 1, 2021).

The original agreement between NMPF and IDFA to replace the previous, higher-of Class III and IV, Class I skim milk price mover with the average-of Class III and IV + \$0.74/cwt mover, was made with the expectation that the two movers would, on average, maintain essentially the same Class I skim milk price, based on the historic record from January 2000 through August 2017. However, the unusual market conditions of the pandemic-driven economy last year, as noted above, revealed that this change exposed dairy producers to an unanticipated asymmetrical risk. The new mover could never be more than \$0.74/cwt higher than the mover it replaced, but it could be lower by a significantly larger amount. During the second half of calendar year 2020, the new Class I skim milk price mover averaged \$3.56/cwt less than the previous, higher-of mover, with December marking the largest difference at \$5.19/cwt lower.

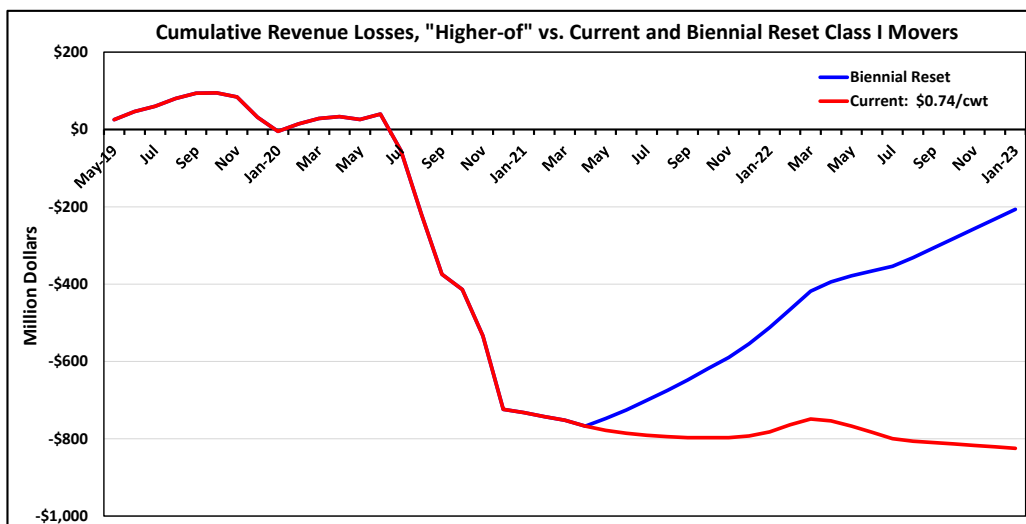
These price disparities have resulted in a cumulative loss of about \$725 million in Class I skim milk revenues to dairy farmers during those six months. It has also contributed to the problem of large negative producer price differentials – of a magnitude never before experienced – in the seven component pricing federal orders, and the consequent de-pooling of large volumes of Class III milk and disruptive pricing of milk to producers pooled on those orders during the period.

The NMPF Economic Policy Committee met several times in late 2020 to consider modifications to the current Class I skim milk price mover to address these problems. The Committee considered two basic options to accomplish this. The first option consisted of modifications to restrict the Class I mover from falling too far below the previous, higher-of mover during any month. The second option included modifications to adjust the current \$0.74/cwt “increment” to the average of Class III and IV calculation to recoup significant losses that occur when the current mover falls well below the previous, higher-of mover.

The Committee also considered a proposal to base the Class I mover entirely on the Class III skim milk price, but it did not recommend this approach, nor did it recommend the first option described above, to modify the current Class I mover to prevent it from falling too far below the higher-of mover. The Committee instead recommended that NMPF retain the current average of Class III and IV basis of the calculation but seek to adjust the current \$0.74/cwt increment to recoup significant losses that occur when the current mover falls well below the previous, higher-of mover. The primary consideration in making this recommendation was to minimize the basis risk in hedging Class I milk, which was the principal purpose for changing the Class I mover from the higher-of in the first place.

Two basic approaches to adjusting the \$0.74/cwt increment were considered. The first would adjust the increment based on a moving average of the difference between the average of and the higher of the advanced Class III and Class IV skim milk pricing factors, with adjustments made quarterly. The second approach would adjust the increment only once every two years, based on this same difference over the prior 24 months of May through April, with adjustments taking effect for the following 24 months of May through April. The increment would not be set below \$0.74/cwt. nor would it be increased if the calculated adjustment were nominal (e.g., less than \$0.05/cwt). The NMPF Executive Committee reviewed the discussions of the Economic Policy Committee and concurred that the biennial adjustment mechanism would be the most balanced approach to address the existing disparities.

This approach of adjusting the Class I skim milk price mover on a biennial, moving average basis would increase the current \$0.74/cwt increment to \$1.63/cwt for the two-year period May 2021 through April 2023, based on the current dairy futures for the next few months. The futures indicate that it would gradually recoup the cumulative losses in Class I skim milk revenues to dairy producers as shown below, while the current mover would maintain that cumulative loss at about \$800 million for the foreseeable future.



Throughout NMPF's discussions, there has been a focus on examining solutions to the Class I mover that restore and maintain balance between outcomes for producers and handlers – a balance that has been demonstrably absent in light of recent economic events. The spirit and intent of this proposed adjustment to the Class I mover is to restore that balance in a manner that maintains handlers' ability to hedge Class I while addressing the harmful, yet unintended, damage to producers of the current mover.