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THE ALLIANCE
OF WESTERN MILK PRODUCERS

Public Forum on the Basic Formula Price

A statement on Behalf of the Alliance of Western Milk Producers

James Tillison, Executive Director

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The Alliance of Western Milk Producers is a trade association that represents the major operating cooperatives in California. These six organizations market milk and manufacture dairy products for a total of nearly 1600 producer-owners producing 70 percent of the state's milk.

The Alliance appreciates being given the opportunity to provide information and options for consideration as the Dairy Division of the USDA's Agricultural Marketing Service proceeds with the daunting task of revising and revitalizing the federal milk marketing order system.

California producers must be involved

During the 1996 Farm Bill debate, the Alliance worked successfully to maintain California's independent state milk pricing system and marketing order. We also worked to ensure that should California dairymen and women choose to become part of the federal milk marketing order system, their $800 million investment in quota would be protected.

Regardless of which decision California milk producers ultimately make -- keep our state system, or become part of the federal system -- the changes the USDA makes to the federal milk marketing orders and prices will significantly affect what our producers are paid for their milk.

An excellent example of this is the situation we currently face with Class 1 prices. Because the California Class 1 milk pricing system is so very different from that used in the federal system, our Class 1 prices will be well over a dollar higher than the Class 1 price in surrounding federal orders. California processors have petitioned the state's Department of Food and Agriculture (CDFA) to "snub" our Class 1 prices at the lower of the Southern Nevada Federal order Class 1 price plus 50 cents or the Southern California Class 1 price. The concern is that the misalignment between State and Federal prices will put our processors at a significant competitive disadvantage in serving out-of-state markets while attracting both packaged and bulk milk into California markets.

If the same basic methodology California uses was used in establishing federal Class 1 prices, dairy farmers in surrounding states would be enjoying higher Class 1 prices instead of our producers facing a potential reduction in theirs.

As demonstrated by the number of California organizations participating in this forum, our intent is to be involved in this process.

The BFP's two purposes

The Basic Formula Price (BFP, formerly Minnesota-Wisconsin, MW) price serves two functions:

1. It is the foundation price and sole price mover for Class 1 and 2 prices throughout the federal order system, and

2. It serves as the minimum handler pay price for pooled Grade A milk used to make cheese throughout the federal order system. (Prior to the advent of the 3a Class, the MW was the minimum price for all Grade A milk used in manufactured products.)

The Alliance assumes the intent of this forum is to address both purposes and determine if a BFP is valid in today's diversified and modern dairy industry.

The Alliance's basic philosophy

Since its inception, the Alliance has had an active interest in milk pricing systems. That interest was brought into focus during the 1995/96 Farm Bill debate. The following are the milk pricing principles that the Alliance members feel should be given full careful consideration as the USDA proceeds with not only looking at the BFP and pricing milk used in manufacturing, but revising federal orders.

The Alliance of Western Milk Producers believes that while markets for manufactured dairy products may be national in nature, markets for fluid milk and farm milk are regional in nature. Regional supply and demand factors and regional price factors and market conditions should be the primary influences on establishing milk prices.

Therefore, the Alliance recommends that the USDA utilize the following concepts in developing a milk pricing system:

1. *Develop a national product-based pricing <u>system</u> for milk used to produce cheese, butter and nonfat dry milk powder. It should use regional prices received by manufacturers for these products and regional costs of manufacturing to establish a regional price for milk used in manufacturing.*

Single-point pricing of milk nationally, whether for fluid or manufacturing use, is an outmoded concept. There have been significant shifts in both population and milk production which render that type of system invalid.

Using actual prices manufacturers in a market area receive for their products provides a more accurate value of the product and, therefore, the value of the milk produced in that marketing area. The actual marketplace is a better indicator of the value of the product produced in an area than a single-point, spot-market price adjusted for "book" transportation costs.

2. *Maintain separate utilization classes for milk used to produce nonfat dry milk and butter, and for milk used to produce cheese, other than cottage cheese.*

Classified pricing combined with the pooling of milk revenues has served dairy farmers well. It allows them to capture the most money possible for their milk as a group. Without it, especially considering the consolidation, concentration and vertical integration of milk processing, milk producers would receive much less for their milk.

Class 3a pricing in the federal order system came about because the MW price was a single-point price, based entirely on competition for milk among cheesemakers in an area of the country that had become a deficit production area. When the Commodity Credit Corporation emptied its warehouses of surplus cheese, the cap on prices that the inventory had represented was removed and cheese separated itself from butter and powder. Butter and powder became the "surplus" products and cheese achieved the status enjoyed by Class 1 and Class 2 products. Butter-powder manufacturers could not generate the revenue to pay the cheese-based Class 3 price and obtained the relief needed. The 3a price was simply a further segmenting of the pricing of milk similar to when federal orders went from two classes of milk to three.

However, the Alliance urges that the 3a price be modified so it is a "true" butter and nonfat dry milk powder milk price. The value of butterfat and nonfat solids in 3a should be based on the market price for butter and nonfat dry milk.

3. *Replace single-point-based Class 1 and 2 pricing with multiple basing point pricing.*

While the size of the distribution areas is growing, fluid milk and related products are essentially regional in nature. Most fluid milk is packaged and sold within a reasonable distance of where it is produced. The minimum price fluid processors pay for farm milk should be based on local supply and demand conditions, not on a single point adjusted for transportation.

This approach means that there would no longer be a need for a single BFP as currently exists. Instead of the Class 1 price being a base milk price plus a differential, it should be a formula price adjusted for changes in dairy commodity values. California has used this type of system for nearly 20 years and we believe it would be ideally suited for a multiple basing point pricing approach in the federal system.

4. *Implement true multiple component pricing of milk in all price classes based on end-product value by classified use. It should recognize the values of milkfat, solids-not-fat/protein and fluid carrier to consumers. Minimum solids content in fluid products should be established to equalize raw product cost among all processors.*

The multiple component pricing system utilized in most federal orders is basically just a redistribution the pool of money the various uses of milk generates. True multiple component pricing would expand the pot by bringing the true value of these components into the pool.

Manufacturers of cheese, butter and nonfat dry milk powder as well as some Class 2 products would pay into the pool based on the pounds of product the milk yields. Class 1 processors are selling food and all the components of milk have a value to them because they have a value to their customers.

Establishing realistic minimum nonfat solids content levels insures all fluid processors are paying the same for farm milk. Without these minimums, there would be inequitable raw product cost among processors.

Pricing products

The price of milk used in manufacturing should be based on the actual market value of the product. That value should be converted to a producer milk component value through product yield pricing where applicable. This system requires determining the price of the product, deducting a manufacturing cost and establishing component values.

The National Cheese Exchange and Chicago Mercantile Exchange and the Dairy Market News' nonfat dry milk price range reports are adequate forms of price discovery. However, they are inadequate for the purpose of determining the minimum price producers should receive for their milk.

Both the National Cheese Exchange and the Chicago Mercantile Exchange are "spot" markets based in the Midwest. As with most spot markets, they reflect an extremely small percentage of total product sales. Both require delivery in the Midwest and, as such, do not reflect the impact on the actual price manufacturers receive from differences in getting the product to the market.

In their capacity as price discovery mechanisms, both exchanges are used as the basis for establishing long-term sales contracts. These contracts are generally for a specific amount over or under the exchange price at the time of delivery. Because of this, exchanges can overstate and understate what manufacturers are actually receiving for their products and what producer milk is worth.

Like the exchanges, the Dairy Market News nonfat powder price ranges serve a price discovery function. And, like the exchanges, it is totally inadequate as a basis for pricing milk.

Class 3a pricing uses the simple average of the high and the low powder prices in the Dairy Market News. A hundred loads could be sold at the high end and a few at the low end and the simple average price would understate the true market value of nonfat powder. This results in an understated milk price paid to producers.

Because of these concerns, the Alliance recommends using an audited survey of <u>all</u> manufacturers in a marketing order area selling butter, nonfat powder, or cheese. This system is fair to both manufacturers and producers. The producer's milk check will directly reflect what all products are actually selling for in the marketplace. The processors milk cost will reflect what the product is actually selling for rather than a spot price determined in a half hour of sales activity.

California has been determining the market value of nonfat dry milk powder for years using an audited survey. The Department of Food and Agriculture (CDFA) decided earlier this year to go to the same system for cheese and butter. A preliminary survey showed that the product values generated by a survey were higher than those "discovered" at the exchanges. The Alliance is sure CDFA will provide USDA-AMS with the procedures manuals and forms used to survey plants.

What products to survey

For butter and nonfat powder, the answer to what products to survey is fairly simple -- bulk products -- butter in 25 kg boxes, powder in either 50 pound bags or larger totes. However, for cheese, the answer is not so simple.

Of the 6.7 billion pounds of cheese produced in the United States in 1995, 2.4 billion pounds were cheddar cheese and 2.1 billion was mozzarella cheese. In California, the breakdown was of the 923 million pounds of cheese produced in 1995, 260 million was cheddar and 450 million was mozzarella. In Wisconsin, of 2 billion pounds produced, 747 million was cheddar and 637 million was mozzarella.

There was some logic for basing minimum cheese milk value on cheddar when it accounted for half of the cheese produced and there is a support program that purchases cheddar cheese. However, the previous statistics clearly show that cheddar only accounts for a little more than a third of total production and the support program as we know it will end in just a few years.

Therefore, USDA-AMS needs to take a serious look at which cheese products to use in establishing a value of milk going into cheese. There are many possible approaches that could be taken including developing a blend price for milk going into cheese using both cheddar and mozzarella. If product-yield pricing is used to establish the value of milk's components in cheese milk, a blend value is more easily determined.

Just as the USDA uses the most common form of cheddar cheese to move the BFP price, it should be able to determine the most common bulk form of mozzarella cheese to use in establishing milk prices. It won't be easy, it may not be practical, but it needs to be thoroughly explored.

Converting product value to milk value

As stated previously, the Alliance strongly believes that producers should be paid for all their milk based on the value of milk's components in the various products in which they are used. For manufactured products like cheese, butter and nonfat powder, this means converting from a product price received to a milk component price to be paid. This requires the use of a manufacturing cost.

In California, the manufacturing costs for cheese, butter and nonfat powder are established through the hearing process. However, they are based on financial data collected through the ongoing audit of plant manufacturing costs. This means that the manufacturing costs, or make allowances, are under constant review. The data collected is made public on a regular basis as well.

There are those who argue that a make allowance guarantees the manufacturer a profit. This is not the case. The make allowance establishes a minimum cost of manufacturing. For a plant to be profitable, it must do two things. First, it must sell its product at a value higher than the weighted average price. Second, it must manufacture the product at a cost equal to or less than the manufacturing cost in the product formula.

California has operated under this system for a long time and has established procedures which CDFA is confident accurately collects the necessary financial data.

The most difficult part of the process is making the decision of what level of production should the make allowance cover. Since the make allowance directly impacts what a producer receives for milk, the level of the allowance impacts producer profitability and, therefore, milk production as well as plant profitability.

This is why the Alliance strongly believes both product prices and manufacturing costs should be established on a "local" level. One can argue fairly convincingly that the use of a single national pricing point for the value of milk in manufacturing as well as the basis for Class 1 prices had as much, if not more, to do with the expansion of milk production in "non-traditional" dairy areas as the 1985 change in Class 1 differentials.

A local system allows market administrators to evaluate numerous factors in determining if a price adjustment is necessary or advisable. It is a difficult task, but a necessary one for administrators to carry out.

Again, the Alliance is sure that the California Department of Food and Agriculture will provide the procedure manuals and whatever other assistance is necessary in evaluating and implementing a cost of manufacturing discovery system.

Responsibility

Data collection on pricing and manufacturing costs should be the responsibility of the Dairy Division of the Agricultural Marketing Service of USDA. Auditors are currently visiting pool handlers on a regular basis to verify market reports and data. It seems natural that their responsibilities will be expanded to audit product sales surveys returned by manufacturers as well as collect manufacturing cost information.

Summary

The value of producer milk depends on the demand for milk in the area in which the producer is located, the mix of uses for milk in that area and the amount of milk that is produced. A milk pricing system must recognize and incorporate all of these factors.

The federal milk marketing order system currently does not adequately reflect them. Going to a multiple basing point pricing system for all uses of milk will recognize the diversity of milk and dairy product production that exists in the dairy industry of the twenty-first century.

The consolidation and concentration of the manufacturing segment of the industry allows the producer milk price to be based on the prices that commodity dairy products are actually being sold. An inclusive survey of manufacturers within a milk marketing region is the most reliable basis for establishing product prices.

The conversion of this product price to a milk component value is accomplished by establishing a cost of manufacture through an annual audit of major manufacturing facilities. In addition, the market administrators must evaluate overall market area supply and demand conditions in establishing and adjusting these make allowances.

Milk processors should pay for the value of the milk components they buy. Dairy farmers should be paid for the value of the components in their milk.

Such a system can work in a multiple market pricing system just as it has worked in California. However, it is unrealistic to expect that it will be right the first time through. The federal order change process must be permanently streamlined so that both at the national and market area level it can be responsive to the fine tuning that will be needed to make the new system work.

The Alliance appreciates this opportunity to provide its thoughts on how the federal order milk pricing system should be revised so there can truly be a national milk pricing system.

Respectfully submitted,
Alliance of Western Milk Producers

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