

Federal Order Issues
Southern Dairy Meeting
Atlanta, Georgia
February 4-5, 2002

Howard McDowell
Economist
USDA-Dairy Programs

The presentation is intended to be a discussion of issues from a broad perspective, and is not in any way a discussion of USDA policy or positions.

Topics

- Federal Order Reform
- Pricing and Classes

Federal Order Reform

- Combined 31 orders into 11
- Replaced BFP and Classes III and III-A with component price system and Classes III and IV
- Specified a single Class I differential for each county
- Possible adjustments
 - Class III and Class IV pricing (EX PARTE)
 - Pooling standards (EX PARTE)
 - Number of classes
 - Order structure – how many, how big, borders

New Market Conditions

- Market Definitions Changed –
 - Larger areas, 31 to 11 orders
 - New pooling standards
 - New differentials
- Market Price Alignment among New Orders
 - Incentives to market milk to higher blend price market
 - Class I utilization and blend prices decrease with more milk pooled on market
 - Shift milk until equalize returns from orders
- Blend Price Changes

Potential Pooling and Order Debate

- Pooling standards – diversion limits
 - Open hearing records (EX PARTE)
- Realign market boundaries of 11 orders
- Increase or decrease number of orders
 - Hearing
 - Vote out, ask for new smaller order, 2-3 years
- Disagreements as to how long the Congressional mandate remains in effect for 11 to 14 orders for Order Reform

FMMO Use Classes

- FMMO historically a fluid milk program
- Classes
 - 1956 – two classes in 45 of 68 orders
 - Chicago – 5 classes, butter and cheese together
 - 1970s - System-wide classification begins
 - 1990 – three classes for virtually all orders
 - 1992 – Class III-A for nonfat dry milk (NFDM)
 - Began in 3 orders, expanded to 27
 - Initial issue – base milk price exceeded net return
 - $(\text{Class III price} + \text{Make}) > (\text{NFDM Revenues})$
 - Balancing role
 - Product-based pricing
 - milk and product prices move together
 - 2000 – four classes and component pricing

Manufacturing Use Prices

- Fluid marketing program needs a base price and manufacturing use price(s)
- Minnesota-Wisconsin Series – 1961-1995,
 - Average price for milk bid by cheese plants
 - Not directly tied to support price
 - Generate minimum FO prices for skim milk and butterfat
- Class III-A – 1992 – minimum price milk in NFDM
 - Alternative to forcing NFDM out of FMMO
- Protein prices – 4 orders in 1994
- BFP – 1995 – Short-term fix for M-W
 - Base month M-W plus changes in wholesale prices for Cheese, Butter AA-A, NFDM, DBM base to current month

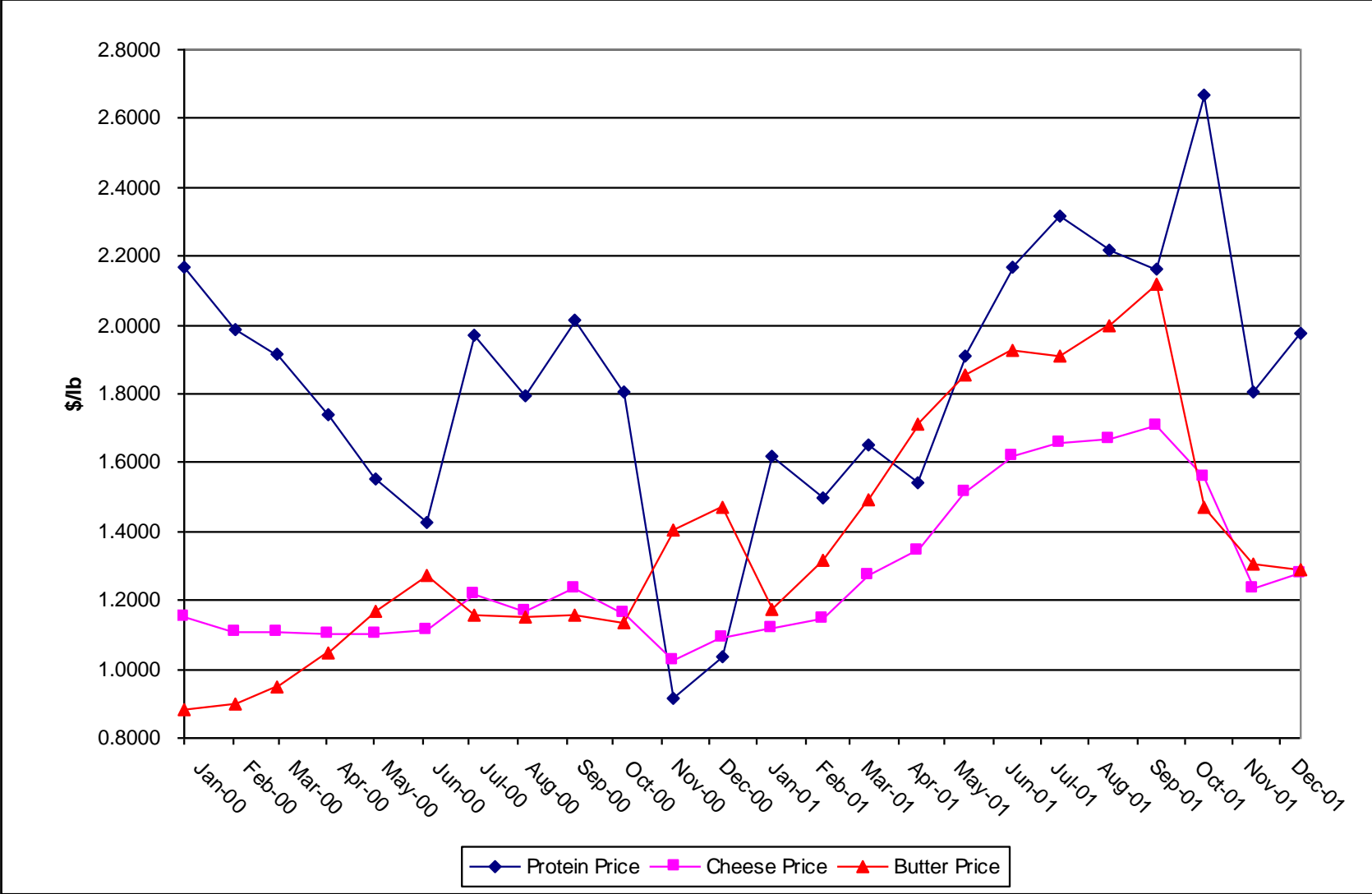
Manufacturing Use Prices

- Federal order reform
 - Component Pricing –
 - butterfat, protein, nonfat solids, other solids
 - Four classes – skim milk and butterfat prices
 - Class I mover – higher of advanced Classes III, IV skim milk prices (EX PARTE)
 - Class II skim milk = advanced Class IV + \$0.70

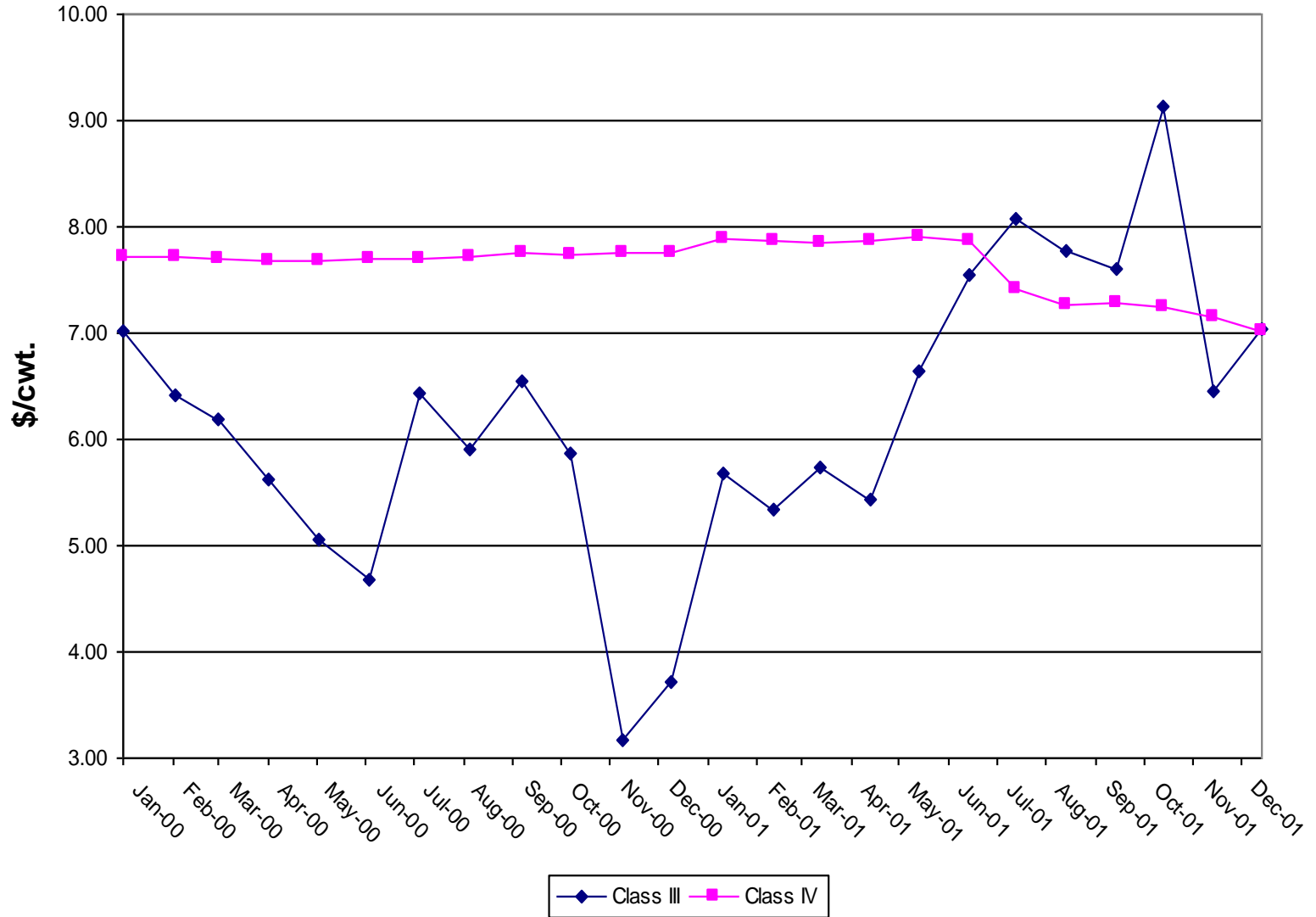
Function of Prices

- Commodity Mix and Input Allocation
 - Fluid milk, manufactured uses
 - butterfat, nonfat solids
 - Short-run market clearance
- Long-term Market Share and Profitability
 - Competition with other food products
 - New product innovation
 - Capital investment
- M-W – initially a competitive milk price
 - Little influence over manufactured uses
 - Move milk to highest value
- Product-based pricing – based on a set of product prices, yield factors, make allowances
 - May influence manufacturing uses

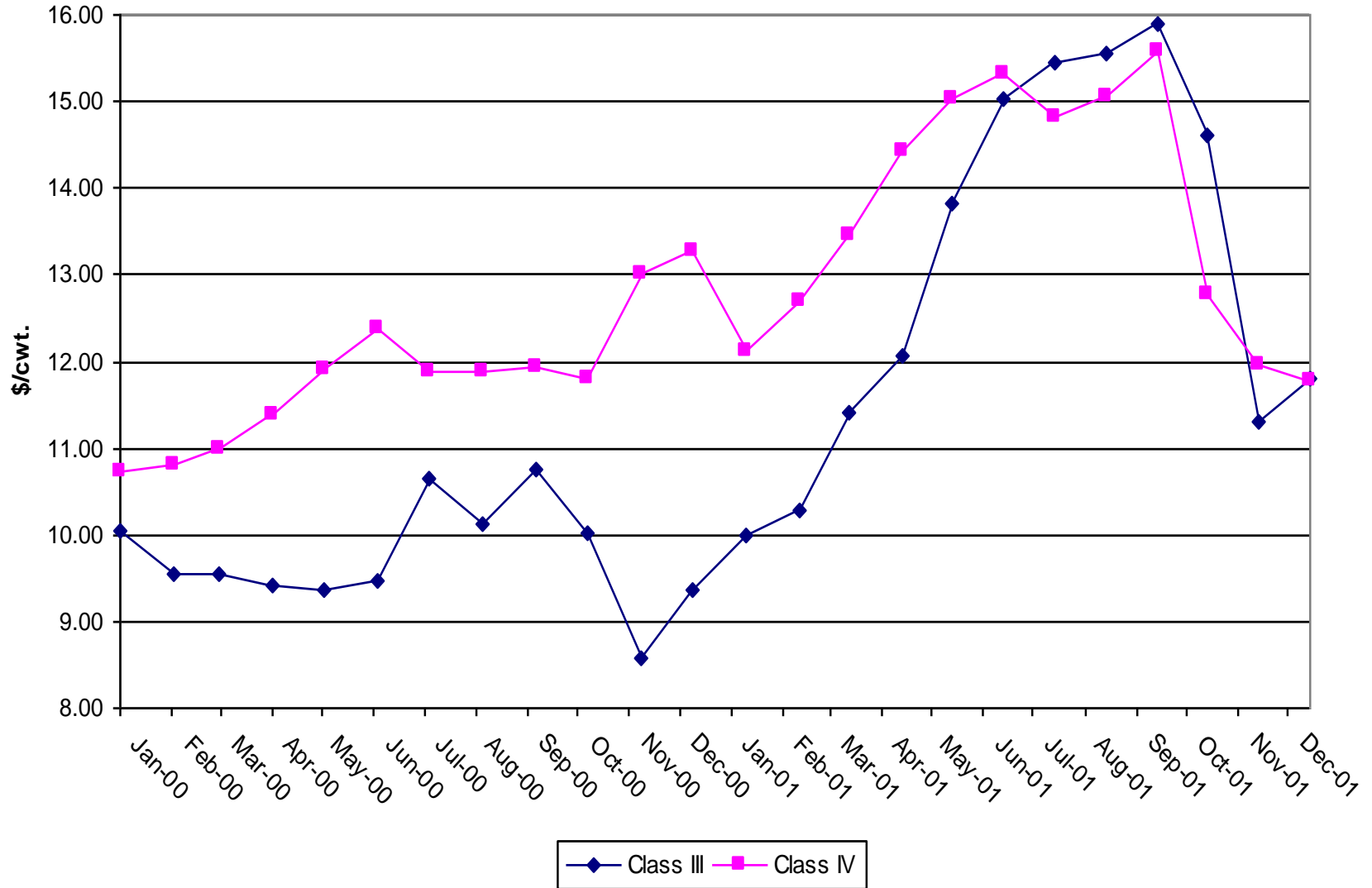
Comparison of Protein Price to NASS Cheese and Butter Prices



Class III and IV Skim Milk Prices



Class III and IV Milk Prices at 3.5 % BF



Class III Issues - Protein

- Class III skim milk and butter prices move inversely
 - Protein value based on cheese yield, adjusted for the value of butterfat in cheese versus the butterfat price
 - Protein price moves inversely with butter price relative to cheese price, current prices above support
 - Protein value based on cheese yield, but paid for in all uses in 7 of 11 orders
 - No US casein or MPCs produced commercially
 - Price support for NFDM
 - Prices 2001 – casein \$2.55; FO protein \$1.96, WPC \$0.77
- Market signals of protein price unclear
- How do actual prices for milk in Classes III and IV compare? How have premiums changed?

Class IV and II Issues - Skim Milk

- Class IV skim milk and butter prices are independent
 - No formula interaction of butter and NFDM prices
 - Support prices can bind Class IV skim and butterfat
 - Under current NFDM support price of \$0.90, the butter price can move up and down and affect the Class III skim milk price, but have no affect on Class IV/II skim prices
- Would FMMO Class IV encourage manufacture of butter/NFDM, at any conceivable price levels ?
 - Make allowance and return to capital, balancing act
 - Butter/powder does play some role in balancing
 - Plant profits increase with larger make allowances
 - FMMO could be a factor, along with support program, in maintaining NFDM/Butter investment versus new processes and new product development

Observations and Questions

- Current discontinuity across Class III and Class IV/II skim prices.
- New milk fractionating technology – UF, RO
 - Fraction accounting, pricing difficulty suggests fewer classes
 - Further development could take place in more classes
- New food technology, demand for dairy and food products
 - Combinations of proteins, fats, minerals, carbohydrates
 - Dairy competes with all sources of components, especially in processed and pre-prepared foods.
- Does the Federal order facilitate the use of dairy components in food products and expand dairy's share of the market?
- Would the manufacturers and producers be better off over time with minimum skim milk and butterfat prices for milk in manufacturing uses, and let the industry move components where most profitable?
- Would more or fewer classes be beneficial?

Industry Discussion

- Requests for hearing on 2-class system
 - Allegations of CME butter price manipulation
 - Pre-reform FO set the minimum price at 3.5 % BF. Increases in current butter price increased the FO butterfat value, but with an offsetting reduction in skim milk value.
 - Current Class IV and Class II skim milk prices based on NASS NFDM, supported at \$0.90 per lb.
 - Unhappiness over “higher of ” Class I mover, citing volatility (EX PARTE)
- CFTC investigations found no manipulation
- Class IV and higher-of less volatile than Class III

Industry Discussion

Possibilities - Fewer Classes, Which Price?

- New unregulated price series
 - Possibility of such a price series unclear – thin markets
 - New competitively bid milk price, similar to old M-W
 - Combine Classes III, IV, and possibly Class II
- Product based formulas
 - Choose higher price for skim price
 - Price squeeze for lower valued use, (recall III-A)
 - Choose lower price for skim price
 - Avoids price squeeze for lower valued use
 - Premiums in the market for higher valued use

Industry Discussion

Possibilities – More Classes?

- Class III – variety of cheeses
 - Different fat and protein content
 - Italian cheeses increasing relative to American
- Protein Powder Classes
 - Facilitate a move to new powders
 - Set make allowances high enough, minimum prices low enough to encourage production
 - Could require further cost sharing relative to returns from NFDM

Summary

- Developing a pricing system with the good qualities of the M-W has proven difficult.
- Federal order reform represented a tremendous change, and is likely to be challenged and modified in various ways.
- The long-term competitive position of any basic food industry is increasingly challenged by technology. It is hoped that the FMMO will help facilitate the dairy industry's position.