

For the past 46 years, milk price regulation in California has been administered by the California Department of Food and Agriculture (CDFA). Regulated prices in the Federal Milk Marketing Orders (FMMO) fall under the jurisdiction of USDA's Agricultural Marketing Service. This Equity Newsletter looks at the differences between the two systems, the process of establishing a FMMO to replace the state milk marketing order, and one potential impact on high component herds.

In early February USDA received a request from California's three largest co-ops (Dairy Farmers of America, California Dairies Inc. and Land O' Lakes) to have California join the FMMO system as its own Federal Order. Upon receiving the co-op request, USDA called for alternative proposals, and received three, one from the Dairy Institute of California representing the state's processors, one from producer-handlers and one from a large Nevada dairy which markets milk into California. USDA is analyzing the proposals and will decide later this summer whether a hearing is warranted. If USDA schedules a hearing, its economic analysis of the proposals will be provided. The hearing will likely begin this fall. After considering the hearing record, USDA will issue a Recommended Decision followed by industry feedback. Then a Final Decision will be announced. California producers will vote on the Final Decision, and if approved, California will become the eleventh Federal Milk Marketing Order. If the Final Decision is not approved, the current CDFA-run milk marketing order will remain in place.

While similarities exist between the CDFA and FMMO systems (classified milk prices based on use, pooling of handler revenues, use of end product price formulas to determine milk component values), there are also significant differences. Among these differences are:

1. CDFA requires all plants receiving Grade A milk to pay CDFA regulated minimum prices. Excess milk cannot be sold to processing plants for less than class value. In the FMMO system, manufacturing plants have the option to participate in the FMMO pool. Furthermore, milk can be sold to manufacturing plants for less than the regulated minimum price for milk. Recently USDA's *Dairy Market News* reported manufacturing milk in the Mideast Order selling for \$3 to \$5/cwt. below Class value. The co-ops propose to retain California's mandatory pooling requirement, while Dairy Institute requests that a California order operate using the same rules as the other FMMOs.
2. California has a quota program, and 60% of its producers own CDFA quota for at least some of their milk. Approximately 17% of the state's production is covered by quota. FMMOs do not provide for quota,

and California producers were not willing to sacrifice quota value in order to become a FMMO. Last year's Farm Bill removed that hurdle by including a provision to allow California to become a Federal Order while retaining the quota program. The co-ops' plan calls for full quota value to be paid from the pooled receipts first. The processors would require producers to choose between federal order pricing or California quota/overbase pricing.

3. California has five classes of milk instead of four, and all five are priced on fat and nonfat solids (NFS). FMMOs price Class I on fat and skim, Classes II and IV on fat and nonfat solids, and Class III on fat, protein and other solids. CDFA bases producer prices on NFS and butterfat, while FMMOs utilizing multiple component pricing base producer pay prices on protein, butterfat and other solids with a producer price differential adjustment (PPD). Both the co-ops and the processors propose a California order to use the same classes and components for pricing as the other FMMOs. The Dairy Institute plan would handle the PPD as it is in the existing MCP orders. The co-ops, however, request the traditional PPD be eliminated, and that producer component prices be adjusted instead. Of all the differences between the co-ops' and processors' plans, the distribution of the PPD could have the most impact on high component herds. Here's why.

In federal orders utilizing multiple component pricing, the order's revenue pool is assembled based on the volume and value of milk utilized in each of the four classes of milk.

Pool Revenue

- Class I receipts based on pounds skim, butterfat and Class I location differentials, plus
- Class II receipts based on pounds nonfat solids and butterfat, plus
- Class III receipts based on pounds protein, other solids and butterfat, plus
- Class IV receipts based on pounds nonfat solids and butterfat, equals
- Total receipts

Pool revenues are distributed to producers by paying Class III prices for the pounds of protein, other solids and butterfat shipped.

Pool Distribution

- Total receipts
 - Protein value
 - Butterfat value
 - Other solids value
- = Pool residual value

The pool's residual value is divided by the total hundredweights shipped by producers and paid to producers on a per hundredweight basis. This distribution of the residual value is known as the Producer Price Differential (PPD). A producer's settlement check would list:

- Pounds protein @ protein price = total protein value
- Pounds other solids @ other solids price = total other solids value
- Pounds butterfat @ butterfat price = total butterfat value
- Hundredweights shipped @ PPD price = PPD value

During normal price relationships when Class I has the highest value, the pool's residual value and PPDs are almost always positive. However, PPDs can be negative. This is most likely to happen in periods of rapidly rising commodity prices when the Class I price (which is advance priced) is less than the Class III price (which is lag priced). For example, in April the Upper Midwest Order pool had a total residual value of \$686,183 after qualified producers were paid for their protein, butterfat and other solids. A total of 2.28 billion pounds of milk were pooled in Order 30 that month resulting in a PPD of \$0.03/cwt. (\$686,183/22,800,000 cwt.).

Both the co-ops and processors propose that a California order assemble the pool's revenue in the same manner as the other FMMOs. California's Class I utilization is approximately 12%, which is roughly equivalent to the Class I utilization in the Upper Midwest Federal Order 30. Order 30's PPDs are typically in the range of \$0.20 to \$0.40 per hundredweight. However, the co-ops propose that the full value of producer quota be paid from the pool first. Given that 17% of California milk is owed the quota premium and only 12% of the state's milk will generate high value Class I revenue, it is very probable that the pool's residual value will be negative most months resulting in negative PPDs. Furthermore, both transportation credits payable to handlers for moving milk to Class I plants and fortification allowances for adding solids to fluid milk to meet California's higher minimum standards will also be owed from pooled receipts.

California FMMO Pool Distribution

Total receipts
 – Quota value
 – Transportation credits
 – Class I fortification allowance
 – Protein value
 – Butterfat value
 – Other solids value
 = Pool residual value

Recognizing the dissatisfaction from producers in existing federal orders on the rare occasions that PPDs are negative, the co-ops propose to manage a California PPD differently. The pool's residual value will be added or subtracted from the component values for protein, butterfat and other solids. The ratio of the components' contribution to the Class III price the previous year will determine the ratio of distributing the residual value among the components. For example, if protein contributes 50% of the total value to the Class III price, then 50% of the pool's residual value will be assigned to protein. Over the past eight years butterfat has contributed between 30% to 44% of the Class III value, protein from 48% to 66%, and other solids 2% to 13%.

To illustrate, in a given month if the pool's residual value is -\$10 million and protein contributed 50% of the Class III value the previous year, \$5 million will be subtracted from the total protein value paid to producers. Carrying the illustration a step further, if producers marketed 100 million pounds of protein that month, the protein price paid to producers would be reduced by \$0.05/lb. Therefore, if the FMMO protein price is \$2.55/lb., California producers would be paid \$2.50/lb.

Of course whether a California order may consistently show negative pool residual values won't be known until a full economic analysis is completed. USDA's Agricultural Marketing Service (AMS) will provide economic analysis should Dairy Programs schedule a hearing.

If the AMS analysis concludes that PPDs will be negative most months, the proposal to distribute PPDs by reducing producer payments for components gives cause for concern. First, it would send the wrong economic signal to producers by lowering the incentive to produce components in a market where nearly 90% of producer milk is used for manufacturing purposes. Second, it would inflict the highest deduction to the component with the greatest value, protein. This again is counter-productive to creating a more market-oriented industry. Finally, it would place an inequitable economic burden on high component producers whose milk has the highest value to manufacturers.

National All-Jersey Inc. will continue to monitor developments in conjunction the California FMMO proposal. If a hearing is convened, NAJ will participate to demonstrate and advocate for equitable payments for milk's most valuable components.