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**Growth and Opportunity for the
U.S. Dairy Industry:**

***Recommendations from Secretary Wolff's Dairy
Policy Round Table Discussion***

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EXECUTIVE SUMMARY

Growth and Opportunity for the U.S. Dairy Industry

Current U.S. dairy policy is too complex and limits market creativity and dairy product innovation. With slow growth in domestic consumption of dairy products, dairy policy changes need to stimulate new product development to meet the growing export market. This would have the added benefit of removing some farm gate price volatility, which is a hardship on producers. These policy considerations, coupled with the 2007 Farm Bill Reauthorization, provide the dairy industry a rare opportunity to fundamentally improve demand and strengthen producer prices.

This brief discussion paper, an outcome of Secretary Wolff's Round Table discussion on dairy policy, assesses current dairy policy and outlines considerations for reform.

Strengthen the Safety Net for Producers: The MILC program has been an important safety net for a large number of milk producers. The Dairy Price Support Program (DPSP) provides very low support price protection for dairy producers. In fact, the DPSP may be hindering our ability to export dairy products. Consideration should be given to eliminating the DPSP and restructuring the MILC program into a new Milk Target Price Program. Such a program would make payments to all producers whenever the Class III price (or manufacturing price) falls below a target level. The program could be modified by limiting the payments on milk production or total dollars spent, or adjusting the target price whenever feed costs rise above a threshold level.

Develop Export Markets: The U.S. is in a good position to become a significant player in the global dairy markets. The U.S. is already a large exporter of whey and lactose, products that are not regulated under the DPSP. Having access to strong markets for dairy products will allow the U.S. to continue to grow beyond domestic markets. But the U.S. could benefit from positive changes. First, the DPSP is a hindrance to producing products for export markets and should be eliminated or adjusted to be more flexible as to not inhibit the manufacture of NFDM for export customers, and to provide incentives for new export product development and associated manufacturing capacity. This change, in combination with improvements in the federal milk order system, would provide processors more accurate price signals to make economically rational production decisions. Instead, processors must currently reconcile their input costs under federal milk orders and the DPSP encourages the production of nonfat dry milk rather than other milk proteins for domestic and export markets. The U.S. should commit to global trade, retool production capacity, develop reliable customers, and meet their needs.

Improve the Federal Order System: Federal Milk Marketing Orders (FMMO) should be revisited and changes considered. For example, the current Class I formula may not reflect market realities and the Class I mover is too volatile. A Class I mover that is current (eliminates forward pricing), moves with the realities of supply/demand, and is more stable would be more feasible. Also, consideration should be given to moving towards a two class system: fluid and manufacturing. In that way, milk components would have the opportunity to be used for the highest and best use. That would benefit dairy producers.

Provide Price Discovery: The U.S. dairy industry could benefit from a reliable and transparent method of price discovery for dairy commodities. It is questionable whether that exists today. The CME market for cheese and butter is thinly traded and FMMOs depend on NASS surveys of dairy commodities. The problem with the latter is that the NASS survey creates a lag in pricing information (about 1-2 weeks) and the survey is not mandatory. In addition, the multiple classes of milk and complexities in price formulas under FMMO make it difficult for the market to see any transparency in pricing. That leads to poor price discovery and limitations in the growth of dairy commodity futures markets. A more viable dairy commodity futures market would better enable dairy producers to manage milk price risk. What is needed are improvements in the NASS surveys (eliminate the lag, make it mandatory, and require daily reporting) or create an alternative to the CME spot market. Livestock markets, for example, have mandatory daily reporting of beef and hog prices. Also, reducing the number of classes in the FMMOs to fluid and manufacturing will help milk move to its highest and best use and provide better price transparency.

Summary

The dairy industry is important to our economy and quality of life and therefore must be nurtured and supported. Having the right federal dairy policies in place will be critical to improving farm income, capturing international markets, and encouraging investments at all levels of the industry – from the farm to processors. For these reasons, we have advanced several considerations to encourage dialogue among policymakers and the dairy community. It is our goal, in the final analysis, that the U.S. dairy industry be stronger – both here at home and around the globe.

Revised January 23, 2007

Growth and Opportunity for the U.S. Dairy Industry

This white paper is designed to convey several constructive changes that, coupled with the Farm Bill Reauthorization, provide the dairy industry a rare opportunity to fundamentally improve demand for dairy products and strengthen producer prices. Having the right federal dairy policy in place will be critical to encouraging growth, capturing international markets, and encouraging investments from the farm to processors. For these reasons, we have submitted these considerations to encourage dialogue among policymakers and the dairy industry. It is our goal, in the final analysis, that the U.S. dairy industry be stronger – both here at home and around the globe.

These considerations are an outcome from a meeting convened by Secretary of Agriculture Dennis Wolff in December 2006 to discuss the future of the U.S. dairy industry. The distinguished group included: Center for Dairy Excellence, Cornell University, New York Department of Agriculture, The Pennsylvania State University, Pennsylvania Department of Agriculture, the University of Wisconsin-Madison, and several private sector dairy industry leaders. These organizations and institutions have not endorsed these considerations but simply shared their expertise from which this policy document was developed.

Introduction

The U.S. dairy industry represents a \$90 billion industry at the retail level, providing a major economic development stimulus, particularly in rural areas. U.S. dairy markets depend on a combination of market forces and dairy policy instruments, but are these dairy policies doing their best to serve the industry, particularly dairy farmers, in light of market changes here at home and abroad?

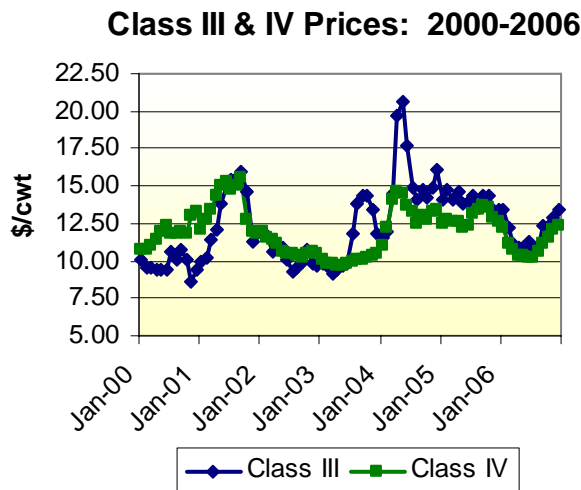
The Northeast depends critically on fluid milk markets. But does volatility in Class I prices under Federal Milk Marketing Orders (FMMO) make sense? Is it helpful or does it hurt retail demand? Also, does the combination of a targeted MILC payment program and the Dairy Price Support Program (DPSP) actually provide a viable safety net for struggling family farmers, or would an alternative approach be more helpful? In addition, does the combination of a thin cash market for cheese and butter at the Chicago Mercantile Exchange (CME), lack of transparency at arriving at Class III and IV prices, and the prevalence of multiple classes of milk hurt price discovery and prevent greater growth in the manufacturing market? A simplified and more transparent federal order pricing system would help the markets better understand how prices are determined. In addition, a move to just two classes of milk—fluid and manufacturing—would allow milk to move to its highest and best uses.

These are just a few of the many questions that were considered in the Secretary's Dairy Policy Round Table on evolving markets and policy instruments. It was generally accepted that the domestic and international markets for dairy commodities are strong and growing and that some minimum producer safety net was necessary given volatile commodity prices. In addition it was accepted that retaining federal marketing orders in the Northeast was vital to milk production in the region. Of particular importance was the concepts of Class I pricing and pooling among active market participants.

Two evolving market forces are driving many of these considerations. First, U.S. dairy producers have historically been expanding milk production at the rate of 1.4 percent per year. But given stagnant growth in domestic fluid milk demand, the U.S. needs to take advantage of the growing export market. The global dairy markets are growing at 2.7 percent a year. Given reduced output in Europe, Australia (due to a sustained drought) and limited growth elsewhere, the world will increasingly turn to the U.S. as a reliable provider of value-added dairy products. But are we prepared for this opportunity? If the U.S. wants to continue to grow year after year and not face declining milk prices, we will have to turn to alternative market outlets such as the global markets.

Market vs. Policy in Driving the Future of the U.S. Dairy Industry

Milk prices have clearly been more volatile since the mid-1980's when market prices moved above support levels. While farm prices at times have declined to painful levels for milk producers, they have also been relatively strong. In fact, the five year average Class III price (2002-2006) is now \$12.64 per cwt, well above the more traditional average of \$12.14 for say 1990-2001. The fact is milk prices have experienced relatively lofty levels whenever the milk supply is limited (due to drought/heat) or demand is strong. For example, recent growth in global demand for protein is sending domestic U.S. prices for dry whey and nonfat dry milk to unheard of levels in 2007. That is strengthening Class III and IV milk prices.



The point is the U.S. dairy industry today depends on strong and growing markets in order to support domestic milk prices. Prices rise and fall as the supply/demand balance changes. Prices don't rise in response to changes in government policies. Stated another way, government policies simply divide up the pie; growing markets, on the other hand, make the pie bigger! If the U.S. dairy industry wants to continue to grow in excess of one percent per year, there must be a home for this milk. And, if milk producers want stronger milk prices they must increasingly rely on markets to support those prices, not new government programs. Thus consideration must be given to policies that support market growth. That means policies that hinder that growth must be revisited.

Some Problems with Current Policy

The U.S. dairy industry currently has a complex collection of competing policies that are not focused on clear objectives and hinder the growth of new markets. This limits our ability to expand our milk supply and find markets for these milk components. For example, current standards of identity for dairy products limits processors abilities to source the milk components they want in the form they want (liquid or dried) and it interferes with innovative dairy product development. Multiple classes of federal orders creates an incentive where skim milk is first dried into nonfat dry milk, which is not suitable for export markets, and then is used to standardize raw milk in the production of cheese. The world market demands skim milk powder, not nonfat dry milk. The dairy price support program (DPSP) in conjunction with make allowances in federal orders encourages the production of products the market does not necessarily want. And the Milk Income Loss Contract Program (MILC) provides limited countervailing price protection to some producers, and not others. What is needed is a clear strategic plan for the U.S. dairy industry and a new approach to policies that will support that plan.

The DPSP provides minimum price support for cheese, butter and nonfat dry milk. In theory it supports the price of manufacturing milk at \$9.90 per cwt. In reality the only support this program has provided has been for nonfat dry milk at \$0.80 per pound. Butter prices and for the most part cheese have traded above support levels. Cheese prices have fallen below support levels at times, but cheese manufactures have been hesitant to use the DPSP because the DPSP doesn't reflect today's commercial cheese trade. Western milk processors, however, have used the DPSP to ship large amounts of nonfat dry milk to the Commodity Credit Corporation (CCC). This policy has provided very limited price protection to U.S. milk producers. In addition, the DPSP has prevented the industry from fully investing in new markets abroad. During the spring of 2006, when supplies of nonfat dry milk were limited, there were weeks when nonfat dry milk was sold into the DPSP. A better approach would be to focus more attention on the growing global protein markets. Plans should be developed to access those markets for long term growth. But the first step in such a plan should be to phase out or move away from the DPSP.

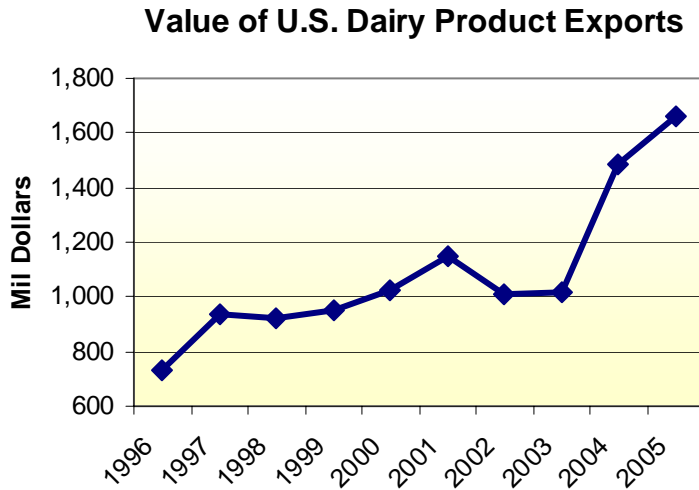
Another area that is limiting growth is the lack of transparency in milk pricing. The cash cheese and butter markets at the Chicago Mercantile Exchange are too thinly traded. Federal orders depend on a non-mandatory NASS survey that introduces lags into the pricing system. The complexity of federal order class prices creates a lack of pricing transparency and basis problems when attempting to forward contract milk. For example, milk producers are hesitant to forward contract Class III milk when they may face an unpredictable basis and negative producer price differentials (PPD). Thus development of new risk management tools that could help facilitate the industry is thus stalled.

Opportunities in Global Dairy Markets

The U.S. dairy industry was excited over hopes and opportunities for global trade in dairy products during the last World Trade Organization (WTO) and Farm Bill negotiations. The U.S. used the Dairy Export Incentive Program (DEIP) to open markets abroad for nonfat dry milk. However, it was the opportunity for commercial trade that offered the most hope. While the U.S. did expand exports in whey, lactose and nonfat dry milk, we also increased imports of dried proteins and milk fat products. To some extent hopes were not fully realized that the U.S. would

become a net exporter of dairy products. Visions of growing export opportunities were largely theoretical. However that is not true today.

The value of U.S. exports has grown substantially over the past ten years, from \$733.2 million in 1996 to \$1.7 billion in 2005. Our top 10 export markets in 2005 in terms of value were Mexico, Canada, Japan, the Philippines, China, Indonesia, Korea, Vietnam, Malaysia, and Thailand. Our 11th market in terms of value in 2005 was Cuba.



Source: Foreign Agriculture Service, USDA, BICO Export Commodity Aggregation

Exports of skim milk powder, the international version of our U.S. nonfat dry milk, grew substantially in 2004 and 2005 (Table 1). In fact, these exports have continued into 2006 and 2007. By exporting our surplus skim milk in the form of skim milk powder the U.S. has seen nonfat dry milk prices rise from support levels of \$0.80 per pound in 2003 to close to \$1.00 per pound in 2005 and more than \$1.00 in 2006. Tighter domestic protein markets resulted in higher cheese prices as well. Thus both Class III and IV prices benefited indirectly from greater U.S. exports of skim milk powder. It is projected that milk prices are expected to rise sharply in 2007 in response to greater U.S. exports of both skim milk powder and dry whey products.

Table 1. Comparison of Exports of Skim Milk Powder and U.S. Prices

	2003	2004	2005
Exports, skim milk powder, MT	130,920	253,982	286,786
Western nonfat dry milk, \$/lb	0.8059	0.8364	0.9485
Class III price, \$/cwt	11.42	15.39	14.05
Class IV price, \$/cwt	10.00	13.20	12.87

Sources: AMS/USDA, and the U.S. International Trade Commission.

Thus demand for growing global trade in dairy products is no longer theoretical. The European Union has ended casein production subsidies, limited entrance of skim milk powder and butter into intervention programs, and severely curtailed export subsidies. And limited milk output in New Zealand and another 3-year drought cycle in Australia have created unprecedented opportunities for export markets for the U.S. dairy industry. Global demand for dairy products is projected to grow at the rate of 2.7 percent per year over the next seven years. This growth rate will be due to a combination of growing per capita demand and population growth. Most growth will come from Asia and in China in particular. Growth will also occur in Brazil, Pakistan, India, and the Middle East/Africa. Even the wealthiest countries in the world are expected to grow two percent per year.

So who are the major global producers of dairy products? Europe is one of the largest producers of milk and dairy products in the world. But they will increasingly focus on meeting internal demand and will continue to export less surplus skim milk, butter and whey products. New Zealand will continue to grow in the range of 1-3 percent, but land is a major limitation. Australia has severe water shortages and is currently experiencing one of the worst droughts in their history. It will take them 3-5 years at best to recover. China is another major milk producer. They are increasing milk production rapidly but will not keep pace with growing demand. Thus they will increasingly become a net importer of dairy products. Brazil is also increasing milk production, but also cannot keep up with growing internal demand. Argentina, Chile, and Uruguay are producing greater export volumes to Latin American countries like Brazil. But social programs and government restrictions are constraining export activities. Russia is another major global producer but faces quality issues and cannot meet internal demand. Ukraine has tremendous opportunities to develop a growing dairy sector, but severe quality issues will limit their abilities as well.

The U.S. is now in a very good position to become a major global leader in the international protein market. An EU withdrawal from the global skim milk markets, strong global demand for dairy products, and limited growth around the world are all presenting the U.S. as a major supplier. In particular, the U.S. could become the dominant exporter of skim milk powder and in effect determine global prices. The U.S. also has increasing opportunities in the export of dry whey, whey proteins and lactose. Cheese exports should be maximized under the Cooperatives Working Together (CWT) program. In addition commercial cheese opportunities could be available in Middle East/Africa with reduced supplies from the EU, New Zealand, and Australia. Thus the U.S. should consider the global export markets as part of a long term strategic plan for sustained economic growth.

Limitations of the Current Safety Net

There is strong interest in revisiting the issue of providing milk producers with a meaningful safety net. Currently that safety net consists of the DPSP and the MILC programs. Yet there are problems with both.

The MILC program paid 45 percent of the difference between \$16.94 and the Boston Class I price during the period December 2001 and September 2006. The percentage was lowered from 45 to 34 percent under the MILCX program which was extended from October 2006 to August 2007. Both programs were limited to 2.4 million pounds of milk per farm marketed during a fiscal year. This is roughly equal to the milk from a farm with 125 cows.

The advantages of the MILC program are that it provides direct counter cyclical payments to about 85 percent of herds in the U.S., which produce roughly 45 percent of the milk. This targeting feature—small farms with less than 125 cows—is also a disadvantage. Large and progressive farms complain that they only receive the payment on a small percentage of their milk. Also, the target level of \$16.94 per cwt is a relatively high level of support. Hence a limitation or targeting feature was required for budgetary purposes.

The DPSP, on the other hand, has provided little direct support for dairy producers. A \$9.90 support price of milk testing 3.67 percent fat is a relatively low support level. In addition the program does not prevent Class III prices from falling below support. In 2000 the Class III price was below \$9.90 per cwt in 7 of 12 months, falling as low as \$8.57 per cwt in November. In 2002 it fell below support during 3 months; in 2003 for six months; in 2004 in one month.

There are many reasons why the DPSP does not act as a floor for Class III prices:

- It costs to sell product to the government
- CCC product specifications are different than that of commercial trade
- Cheddar blocks and barrels are a decreasing share of cheese production
- An increasing amount of cheese is now committed under contractual arrangement between cheese makers and buyers, thus they are not free to sell cheese to the CCC
- The value of dry whey is an important factor in determining the Class III price, but it is not part of CCC purchases

There are other disadvantages to the DPSP other than providing a poor price floor to dairy producers:

- Non-market influences interfere with the U.S. Secretary of Agriculture in administering the CCC purchase price program. This is particular true in setting the butter/powder tilts.
- The \$9.90 support program is a concern with the WTO as it accounts for 25 percent of our allowable Aggregate Measures of Support.
- The attractiveness of sending nonfat dry milk to the CCC is tempting for domestic processors. Why take the risk of investing in new technology and products when the CCC is willing to purchase all surplus products at fixed prices? This limits our ability to develop reliable export markets with real customers.

Ideas for Strengthening the Producers' Safety Net

The MILC payment program has been an important safety net for a large number of U.S. dairy farms. This program is set to expire prior to the beginning of a new Farm Bill. That means future spending on this program will no longer be in the Congressional “scoring” that is crucial for farm policy discussions. This may force the dairy industry to reevaluate the issue of a producer safety net from scratch.

The Round Table participants identified three ideas for improving the safety net for milk producers. This involves phasing out the DPSP and restructuring the MILC with a new program called the Milk Target Price Program, improving risk management tools to expand into revenue insurance for milk producers, and funding the Dairy Options Pilot Program (DOPP) in order to provide producers with greater experience with milk futures and options.

One of the incentives for restructuring the MILC program is to make it more appealing for all milk producers. In addition, an incentive for phasing out the DPSP is that this program has limited regional appeal. Table 2 clearly illustrates that while spending under the MILC program has been geographically disbursed; spending under the DPSP is clearly concentrated in the West, mainly in California.

Table 2. Dairy Program Payments: MILC and CCC Purchases Under the Dairy Price Support Program (DPSP), FY 2000-2005, Mil. \$

Region	MILC	DPSP
West	295.6	2,131
Northeast	467.9	70.1
Midwest	919.5	28.7
South	299.3	81.9
Total	1,982.3	2,311.7

Source: USDA's Farm Service Agency, Commodity Credit Corporation.

The Milk Target Price Program would make a payment to all producers whenever the Class III price falls below a determined target level. We analyzed payment levels that ranged from \$10.50 to \$12.50 per cwt and compared them historically to the MILC program. The results are in Tables 3 and 4.

Our analysis shows that the Milk Target Price Program would not initially be as generous to milk producers as the MILC program has been. For example, the average MILC payment was \$0.63 per cwt over the period 2002-2006. That compares with \$0.17 per cwt for a \$10.50 target, \$0.29 per cwt for a \$11 target, \$0.47 per cwt for an \$11.50 target, and \$0.56 per cwt for an \$11.75 target. The target level would have to be over \$11.75 per cwt to reach the same per unit level of support as the MILC. But, these payments are only on eligible milk, the 2.4 million pound cap. The Milk Target Price Program, unlike the MILC, would pay 100% of the difference between the target price and a lower market price. The cost of a Milk Target Price Program has been estimated to average \$290-\$1,593 million per year over the period 2002-2006 depending on the level of the target price. It should be noted that the MILC does not make payments to all milk produced in the U.S., whereas the Milk Target Price Program would. And the revised Milk program could be structured so that it is cheaper than the combined costs of the DPSP and the MILC. For example, over the FY's 2000-05, CCC outlays for dairy programs averaged \$716 million per year (source: USDA/FSA). Costs for the proposed Milk Target Price Program could be contained by using a payment cap on per farm milk production or total spending. A cap would need to be discussed in light of budget limitations.

Table 3. Comparison of the Per Unit Payments Under the MILK and a Milk Target Price Program, January 2002 – December 2006

Year	MILC	Target Price/Deficiency Payment					
		\$10.50	\$11.00	\$11.50	\$11.75	\$12.00	\$12.50
-----\$/cwt-----							
2002	1.21	0.38	0.71	1.13	1.34	1.58	2.08
2003	1.09	0.47	0.72	0.97	1.09	1.24	1.58
2004	0.22	0.00	0.00	0.00	0.01	0.04	0.13
2005	0.01	0.00	0.00	0.00	0.00	0.00	0.00
2006	0.61	0.00	0.03	0.24	0.36	0.49	0.80
Average	0.63	0.17	0.29	0.47	0.56	0.67	0.92

Table 4. Estimated Cost of a Milk Target Price Program, January 2002 – December 2006

	Target Price Levels					
	\$10.50	\$11.00	\$11.50	\$11.75	\$12.00	\$12.50
-----Million Dollars-----						
2002	635	1,194	1,906	2,277	2,684	3,533
2003	813	1,248	1,684	1,901	2,169	2,747
2004	0	0	0	20	71	211
2005	0	0	0	0	0	0
2006	0	50	444	677	910	1,475
Average	290	498	807	975	1,167	1,593

Risk management products, such as the Milk Revenue Insurance proposal recently submitted by a group of northeast states to the USDA Risk Management Agency, could play an important role in providing a safety net to dairy producers. The Milk Revenue Insurance concept, if implemented, would provide dairy producers with protection for the major source of revenue upon which their livelihood depends. It would enable them to purchase insurance based upon the 5-year trend adjusted average milk revenue per cow for their operations and provide income protection against milk revenue losses from natural disasters and price fluctuations. In addition, traditional crop insurance programs could be used by producers to further protect their feed crops. This risk management combination could be a very effective tool for producers to help insure profitability.

A final option for strengthening the producer safety net is to provide milk producers with greater experience in using the futures markets to lock in profitable prices. There are two policy areas that could be addressed. First, the DOPP program could be re-implemented in order to provide milk producers with actual experience in trading milk options. Second, the Dairy Forward Contracting Pilot Program could be re-implemented. This program would allow proprietary cheese processors and not just cooperatives regulated under federal orders to offer their members a forward contracting program.

Better Price Discovery and Transparency

One of the corner stones of any commodity market is good price discovery and transparency in setting prices. Successful commodity markets share several things. One is a frame of reference or access to a spot or cash market. For example, the S&P 500 has the spot price calculated and disseminated every minute of the day. Livestock markets have cash market prices reported every day. Transparency in pricing is also important. Markets need to understand how prices are arrived at and the market fundamentals that drive those prices. Market information, such as supply and demand, should be readily apparent.

None of the above accurately describes the dairy commodity markets today. The cash and futures markets for cheese and butter trades in the same location daily (at the CME), which is unusual for most commodity markets. The cash cheese and butter markets have very little actual trades relative to the amount of product produced. The industry finds dairy pricing complex and often confusing. For example it is difficult to relate the daily cheese and butter prices to the monthly Class III price. And while the CME at least publishes daily prices for cheese and butter, the Agricultural Marketing Service publishes prices for cheese, dry whey, buttermilk, and nonfat dry milk only weekly. USDA reported NASS survey prices of dairy commodities appears out of sync with the weekly market reported prices due to lags in reporting. This survey of prices is not mandatory. And while futures markets for dairy are only in their infancy, they have a long way to go. For example, milk producers still face tremendous basis risk in trying to protect milk prices via the Class III milk futures contract. There are also policy risks as well. For example, market participants who took forward positions in the Class III markets now find out that a change in USDA policy (raising the make allowance) will reduce the Class III price by \$0.25 per cwt starting in March 2007.

There is much the industry can do to improve price discovery in the dairy industry. Ideas include:

- Mandatory daily reporting of all dairy commodity prices
- Remove any lags in reported NASS survey pricing
- Audit price reporting and create sanctions for noncompliance
- Move away from the CME cash market and require daily processor reporting of all sales and transactions (like in the livestock industry)
- Simplify the federal order system (move to just two classes) in order to improve pricing transparency and reduce the risk of basis or negative PPD's
- Improve the use and creation of forward pricing tools such as futures contracts and options
- Encourage USDA to provide better reporting of market fundamentals for the dairy industry. This will help the industry better understand price movements.

Improving Federal Milk Marketing Orders

Federal Orders are not typically considered when discussing the Farm Bill. However, due to the amount of time required by USDA to implement even the smallest changes and the need for better integration of federal orders with overall dairy policy, consideration should be given for changes in the new Farm Bill.

There is currently strong support for federal orders and the functions of classified pricing (setting different prices for different uses of milk) and pooling of Class I revenues. The pooling of Class I milk is particularly important in the Northeast where producers are directly serving customers in Class I fluid markets. That said, greater consideration should be given to improving and strengthening federal orders as part of an overhaul of the entire dairy policy system.

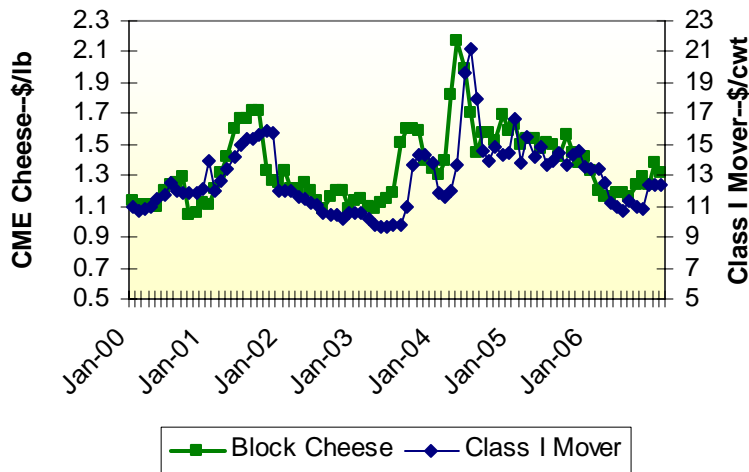
Class I pricing needs to be reconsidered. The Class I price is equal to the Class I differential (set by Congress for each county in the U.S.) plus a national Class I mover. Currently this Class I mover is forward priced based on a two-week NASS survey of commodity prices. This introduces a confusing link to the commodity markets in the price discovery system. And, the Class I mover is largely driven by cheese prices (see figure below). A historical review of the data suggests that volatility in Class I prices has resulted in volatility in retail milk prices. This in turn has raised the farm-to-retail margin over time. Thus, if volatility in the Class I pricing formula has created higher retail prices for fluid milk that would reduce fluid milk consumption (assuming even the lowest retail price elasticity). Lower fluid milk sales would result in more milk moving into manufacturing, thus lowering cheese and butter prices.

A better approach would be to link the Class I mover to a more fundamental measure of supply and demand. One idea would be to eliminate any forward pricing and use the new manufacturing value of milk as the Class I mover. Another consideration would be to use a 3-month moving average of the manufacturing value in order to reduce retail price volatility.

A second consideration would be to move to a two class system for pricing milk under federal orders: one for fluid milk and another for manufacturing milk. The manufacturing price could be driven by simple indexes of component prices (butterfat, protein, and lactose/minerals). This would greatly simplify the pricing system and milk components would move to their highest and best use.

A final consideration would be to partially deregulate the manufacturing market by allowing the local and regional markets to determine component prices and manufacturing values for milk. This information would be determined and reported to the public on a daily basis. This would eliminate the need for complex component formulas and make allowances. While this seems to be a very controversial proposal, it works on a daily basis in the livestock markets where buyers and sellers meet to determine and disseminate prices.

Comparison of the Class I Mover to the Chicago Block Cheese Price



Summary and Conclusions

Milk producers, processors, and retailers are part of a growing \$90 billion industry in the U.S. However growth in this industry is hampered in part from eighty years of federal regulations. Despite these regulations the industry continues to grow. But could growth be stronger by reevaluating these policies?

Secretary Wolff's Dairy Policy Round Table took a fresh look at all dairy policy and reached several important conclusions:

- Dairy farmers want to continue to expand their businesses from one year to the next
- There are growing opportunities for reliable global export markets
- Producers need a meaningful safety net
- Dairy markets are too complex and in need of better pricing transparency
- Federal orders should be simplified and improved in order to facilitate market performance, improve transparency, and better price fluid milk
- Domestic markets are strong but stagnant

The dairy industry deserves a fresh new look at dairy policy to ensure every market opportunity is fully explored, profits are strengthened, and growth can continue.