NAJ *Equity Newsletter* September 2015

Vol. XLI, No. 4

During the first week of August, USDA announced a public hearing to consider proposals to establish a Federal milk marketing order in California. The hearing notice included four proposals which were submitted by (1) cooperatives marketing milk in the state (Dairy Farmers of America, Land O' Lakes and California Dairies Inc.); (2) the Dairy Institute of California (representing processors); (3) Ponderosa Dairy; and (4) the California Producer Handler Association (CPHA). Because California produces 20% of the nation's milk, changes in the California dairy economy will undoubtedly impact the rest of the nation's dairy industry. Therefore, in conjunction with the hearing notice, USDA also published a preliminary economic impact analysis each proposal would have on the California and dairy industries. This issue of the *Equity Newsletter* will focus on the co-op and Dairy Institute proposals because they project to have the greatest impact.

The Cooperative Proposal

The Cooperative proposal retains many features of existing federal milk marketing orders including four classes of milk, end product price formulas, and producer-handler exemptions. However, the co-op plan also calls for three significant differences from the other federal orders. First, the co-ops would require all Grade A manufacturing plants to be pool plants. The other federal orders allow manufacturing plants the option to be pooled or not pooled. Second, the co-ops would retain California's existing producer quota volumes and the accompanying higher price for quota milk. Approximately one-half of California producers own quota for some of their production. Third, the Cooperative proposal would distribute the pool's producer price differential (PPD) by adjusting producer component payments instead of using a per hundredweight payment as is done in the other multiple component pricing orders.

USDA's economic analysis covered the years 2017 to 2024. The impact of the Cooperative proposal is very different for California producers compared to producers in the rest of the country. If implemented, California will experience higher Class II and III prices due to replacing the current CDFA price formulas with FMMO formulas in addition to requiring all milk be pooled. While the FMMO prices would lower California prices for Class I and IV milk, the net impact projects to an average annual increase in the state's all-milk price of $1.03/cwt. In turn, USDA expects California to increase annual milk production by an average of 540 million pounds. Combined with higher milk prices, the Cooperative proposal could result in an annual gain of $700 million in total producer revenue for the state.

However, USDA's analysis shows that increased production in California will negatively impact producers in the rest of the country, with the exception of the unregulated area of the former Western Order (Idaho and Utah). The additional California milk will lead to more cheese, butter, nonfat dry milk and dry whey production and lower prices for those commodities, and, in turn, lower protein, butterfat and other solids prices. Lower milk prices will likely reduce milk production throughout the rest of the U.S. USDA predicts that over the eight-year period, the all-milk price in the Florida Order will decline by an average of $0.24/cwt., while the Southeast Order will lose $0.22. It expects a drop of 11 to 13 cents/cwt. in the all-milk price in seven of the other eight FMMOs. Lower prices combined with less production would result in a projected annual loss of producer revenue of $230 million over all regions of the country other than the aforementioned Idaho and Utah.

The Cooperative plan to adjust producer component prices based on the value of the PPD is of particular concern to high component producers. PPDs will very likely be negative most months if the Cooperative plan is adopted. This is because the value for quota milk that must be paid from the pool will likely be greater than the value of Class I revenue added to the pool. Accounting for the PPD by lowering producer component prices instead of assigning the negative value on a per hundredweight basis as the other multiple component orders do will lead to greater price reductions for high component milk than for low component milk. Additionally, devaluing components sends producers the wrong economic signal in a market that uses over 80% if its milk for manufacturing purposes. The May 2015 *Equity Newsletter* analyzed this issue in greater detail and can be viewed via this link: http://bit.ly/1VBPXwU.

The Cooperative's request for mandatory pooling provides another clue that the co-ops expect PPDs to be negative most months. In the other federal orders, manufacturing milk is attracted to the pool by the prospects to draw money from the positive PPD. If the co-ops expected California's PPDs to be positive

most months, there would be no reason to require manufacturing milk to be pooled. Additionally, low volume processors, such as artisan cheese makers, would be negatively impacted by the proposed mandatory pooling. In the other federal orders, these processors simply opt not to pool their milk. If the Cooperative plan is adopted, not only will it impose a regulatory burden on artisan cheese makers, but given the expected negative PPDs, they will be required to pay into the federal order pool.

The Processor Proposal

The processors' proposal as submitted by the Dairy Institute of California *(Institute)* would utilize the same four classes of milk as the existing federal order system. The Institute plan calls for the use of end product price formulas, although their proposal would use prices and manufacturing costs (make allowances) from only western plants instead of U.S. average prices and costs. Consistent with the other federal orders, the Institute proposal allows milk used for manufacturing the option to be pooled or not to be pooled.

The most significant impact expected from the processor plan comes from the proposed modification to the price formulas. Basing component prices on just western plants would result in California protein prices that are 20.7 cents per pound less than the other FMMOs, butterfat prices that average 2.6 cents lower, other solids prices 4.1 cents less, and nonfat solids prices that are 5.7 cents less. The USDA analysis projects that handlers will not pool approximately 18 billion pounds of manufacturing milk per year, roughly one-third of California's annual production.

The net result of the Institute proposal would be an average annual increase in California's all-milk price of $0.10/cwt. for the eight-year period. The projected effect of this increased price would be increased production of a modest 60 million pounds per year, and an increase in total producer revenue of $70 million.

The Institute plan's impact on other producers in the rest of the country would be mixed. The U.S. all-milk price is projected to increase by $0.07/cwt., but the impact on individual orders varies widely. At the extremes the Southeast Order would experience a $0.23/cwt. decrease in price, while Upper Midwest Order producers would enjoy a $0.24 increase in price. Seven of the other eight Orders would see their prices impacted between -$0.07/cwt. and $0.09/cwt. Production outside of California is expected in climb by 390 million pounds per year, and its associated producer revenue would increase by $160 million.

Importance to High Component Producers

NAJ sees three aspects of the Cooperative and Institute proposals that should be of interest to high component producers.

First, California's current system pays producers for nonfat solids (NFS) instead of pricing NFS individual components of protein and other solids. NFS pricing signals producers that protein and other solids have the same value, and they do not. In the Federal milk marketing orders the NFS price averaged $1.5844/lb. in 2014 and $1.4831 in 2013. Those same years the FMMO protein price averaged $3.7935 and $3.1240/lb., and the other solids price average $0.4684 and $0.4488/lb. The impact of NFS pricing is that producers are underpaid for protein and overpaid for other solids. Having those two components priced separately will provide producers with a clearer economic signal to produce protein.

However, both the Cooperative and Institute proposals include provisions that could result in producer component prices that are lower than in the other federal orders utilizing multiple component pricing. The co-op plan will assign PPD values (which are expected to be negative) to components. The processor plan calls for different end product price formulas than are used in the other federal orders. If adopted, component values will be lower in a California federal order than the other FMMOs.

Finally, the Cooperative plan to require all milk used for manufacturing to be pooled could bring an unnecessary burden on low volume processors such as artisan cheese makers.

The hearing is scheduled to begin on September 22 in Clovis, CA, and is expected to continue for several weeks. National All-Jersey is gathering data and preparing analysis which will be presented at the hearing in support of equitable milk pricing. For the first time California producers could have their regulated milk price be based, in part, on protein. It is critically important that the pricing structure provide producers with a clear economic signal as to protein's value.

National All-Jersey Inc. 6486 East Main Street, Reynoldsburg, OH 43068 www.usjersey.com
614-861-3636 VOICE naj@usjersey.com 614-861-8040 FAX