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California Federal Milk Marketing Order

USDA Publishes Recommended Decision

USDA released its recommended decision that a Federal Milk Marketing Order (FMMO) be established in California on February 9, 2017, nearly two years after three co-ops submitted their original petition requesting a promulgation hearing.

In the interim,

- California's dairy processors and two producer-handlers submitted three alternative proposals.
- A hearing was convened in September 2015 that lasted nearly two months and generated over 8,000 pages of transcript and more than 100 exhibits.
- Fourteen post-hearing briefs were filed, which were followed by 15 reply briefs.

In their request to establish the FMMO, Dairy Farmers of America, California Dairies Inc. and Land O' Lakes proposed that a California order retain several features that are unique to the existing California state order, but that are not part of many, if any, other FMMOs. Conversely, the Dairy Institute of California, representing the processors, took the position that a California order should be patterned similarly to the existing FMMOs. USDA's recommended decision, if adopted, would establish a California order that adheres closely in structure to the other ten federal orders.

Mandatory pooling

A unique feature requested by the co-ops was that all Grade A milk processed within California be mandated to be pooled. In fact, prior to the hearing the co-ops' stated position was that mandatory pooling was one of two critical issues associated with their proposal. All FMMOs require Class I milk to be pooled, but manufacturing milk has the option to be pooled. **USDA's recommendation retains optional pooling for Class II, III and IV milk in the proposed California order.** Milk that is not pooled is not subject to regulated minimum pricing. Given that Class I milk typically has the highest value, in the other FMMOs manufacturing milk opts to be pooled most of the time in order to share in the Class I revenue. However, given California's low Class I utilization, the value of manufacturing milk could be higher than the order's blend price many months. Therefore, processors will have little incentive to pool manufacturing milk, which led to the co-ops requesting that all manufacturing milk be pooled.

Quota value

Retention of California's quota system was the co-ops' second primary issue in conjunction with proposing a California federal order. Within the California state order, approximately 17% of the state's production carries quota, which is worth $0.195 per pound of solids-not-fat (SNF) above the monthly blend value for SNF. In administering the state milk order, the California Department of Food and Agriculture (CDFA) collects enough money from all producers to pay the quota value to quota holders.

The co-ops proposed that in conjunction with mandatory pooling, a California FMMO be authorized to deduct sufficient funds from pooled receipts to pay quota value. **Because USDA is not recommending that all milk be required to be pooled, the FMMO would have no authority to collect money from non-pooled milk to cover the value of quota. USDA did provide a path for California's quota system to remain intact.** The quota system will need to be administered by CDFA, and CDFA will be responsible for assessing and collecting quota funds from both pooled and non-pooled milk and distributing the quota value to quota holders.

Multiple Component Pricing

The California order will operate as a multiple component pricing order. The order will use the same four classes of milk and price formulas as the other FMMOs. Producers will be paid for their pounds of butterfat, protein and other solids, along with a producer price differential (PPD) paid on a per hundredweight basis. The co-ops proposed that the PPD be paid to producers as an adjustment to component values. At the hearing NAJ argued against the co-op approach on the basis that PPDs could be negative most months, and thus producer component values would be reduced. USDA agreed with NAJ's view.

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Fortification Allowance

California state statute requires minimum SNF content for fluid milk that is higher than federal standards. Condensed skim is typically added to fluid milk to meet the higher state standards. While Class I processors are required to buy the additional milk solids, the California state order allows processors a fortification allowance to cover the cost of handling the condensed skim. USDA's recommended decision eliminates the fortification allowance due to processors. **Because high component producer milk requires less fortification to meet California's SNF standards for 2% and 1% milk, bottlers will have two incentives to seek out high component milk.** First, because the Class I skim price does not account for SNF content, the extra SNF in high component milk will not increase Class I processors' skim price over average solids milk. Second, by starting with high component milk, processors' fortification costs will be less for 2% and 1% milk, thus incentivizing them to procure high component milk.

Economic Impact

USDA published an economic analysis based on adoption of the recommended decision. The projections include milk prices, milk production, commodity production and commodity prices from 2017 through 2025 for each federal order. The analysis estimates that California blend prices at producer test will average \$0.52/cwt. higher with the federal order. The Upper Midwest order projects to average \$0.50/cwt. more, and the other FMMOs will range from \$0.28 higher (Southwest Order) to -\$0.21 (Central Order) and -\$0.19 (Arizona Order). Nationally, producer revenue is projected to increase an average of \$740 million per year for nine years. However, while the initial numbers look great, a closer look raises questions.

The analysis assumes that California will produce less cheese from milk that is pooled, and, therefore, less cheese produced results in higher cheese prices (\$0.06/lb.). In turn, Class III prices are projected to increase by \$0.66/cwt. NAJ anticipates that California's total cheese production from both pooled and non-pooled milk will not change by much from current levels. Therefore, the impact on the price of cheese and subsequently the impact on the Class III price will be minimal. In addition, higher regulated prices will probably erode over-order premiums, thus minimizing any actual price increase received by producers. Finally, the analysis does not account for the volume of milk processed by non-pool plants that will be sold for below class price. In fact, the analysis states that as much as 40% of the projected \$740 million average annual increase may be overstated due to the combination of reduction in premiums and below class sales.

Undoubtedly both Class I and II revenues should increase in California if a federal order is adopted. The Class I price is based on the higher of Class III or IV, and those FMMO prices are usually higher than the comparable California state order prices. Federal order Class II milk processed by Class I plants is also required to be pooled, which will result in higher Class II revenues. However, the combined revenue enhancement from Class I and II will not approach the total dollars estimated in the economic analysis.

Next steps

Dairy Programs held an information session February 22 in Clovis, California. Interested parties have until May 15, 2017 to file comments about the recommended decision. Dairy Programs will analyze the comments and issue a final decision, most likely this fall. An updated economic impact analysis will be made available at that time. The final decision will go to producer referendum. A two-thirds majority of qualified California producers or milk is required for the federal order to be adopted. Co-ops can bloc vote for all their members. If adopted, there will be a transitional period from the California state order to the federal order which could span three to six months.

The outcome of the producer vote will probably depend on four issues:

1. CDFA's ability to continue the state's quota program.
2. Producers' willingness to accept non-mandatory pooling.
3. The projected economic impact of implementing a federal order compared to retaining the existing California state order.
4. The impact of eliminating the fortification allowance.

USDA's publication of a recommended decision brings the California hearing process to the point that, to quote Sir Winston Churchill, "Now this is not the end. It is not even the beginning of the end. But it is, perhaps, the end of the beginning."

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