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MILK MARKETING ORDERS

Issues for Consideration in Reauthorizing the Farm Bill in 1995

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Mr. Chairman and Members of the Subcommittee:

We are pleased to be here today to participate in your hearings related to federal milk marketing orders. In deliberations on the 1995 farm bill, the Congress will again be considering changes to the U.S. dairy program. To aid in these deliberations, we would like to discuss some of the issues we have raised about the Milk Marketing Order Program. Our comments are based primarily on two reports we have issued: a 1988 report on options for changing milk marketing orders, and a 1995 report on dairy pricing.[1]

In summary, the market environment that led to the creation of the federal dairy pricing system has changed and the premises for milk pricing under federal orders are outdated. As a result, milk marketing orders have contributed to excess production and inequitable treatment of some producers. These conditions exist because the orders guarantee producers in some areas of the country higher prices than producers in other areas, even though production costs might be the same or less. Two pricing components of federal milk marketing orders contribute to these conditions--first, an incentive to increase the production of higher quality fluid milk for drinking purposes (grade A) and secondly an incentive to make it profitable for traditional surplus milk production areas to ship milk to traditional areas of insufficient production. Several alternatives are available for addressing these issues.

BACKGROUND

The federal Milk Marketing Order Program, created in 1937 largely in response to unstable market conditions, regulates the marketing of milk in those areas of the country where producers have voluntarily adopted them. Milk marketing orders were created in part to encourage and maintain a locally produced supply of fluid milk. At that time, transporting fluid milk was difficult because the necessary technologies to avoid spoilage--refrigeration

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1Milk Marketing Orders: Options for Change (GAO/RCED-88-9, Mar. 21, 1988) and Federal Dairy Programs: Information on Dairy Pricing and Related 1995 Farm Bill Issues (GAO/RCED-95-97BR, Mar. 27, 1995).

and reconstitution--did not exist. Furthermore, the transportation infrastructure was not developed enough to make long hauls feasible. Additionally, because the federal government was concerned about assuring adequate supplies of high quality milk for fluid use, it provided incentives for producers to upgrade their facilities to meet the higher sanitation standards for grade A milk.

Milk marketing orders, which are supervised by the U. S. Department of Agriculture, set forth marketing practices, terms and conditions of sale; minimum prices that must be paid by processors to producers; and distribution of returns among producers. Orders apply only to grade A milk, which is produced to specific sanitary standards and is eligible for fluid consumption, regardless of end use. The majority of milk produced in this country is used for manufactured dairy products, even though about 90 percent of the milk produced is grade A.

In the 1960's, a uniform pricing system was started under milk marketing orders, based on competitive prices paid for grade B milk by selected manufacturing plants in Minnesota and Wisconsin. These prices are the basis for all prices paid to producers delivering milk to plants regulated by federal orders east of the Rocky Mountains. Milk marketed west of the Rockies is influenced by prices in California, which has its own state milk pricing system and is not covered by federal orders.

Fluid milk prices under federal orders have two components in addition to the Minnesota-Wisconsin price which applies to milk used for manufacturing. One component, a grade A differential, is a $1.04 per hundredweight (cwt) incentive to encourage farmers to upgrade their facilities to meet the higher grade A sanitary standards. The other component, a distance differential, increases the guaranteed price for milk used for fluid consumption and is generally based on the distance a plant is located from Eau Claire, Wisconsin, commonly called the basing point. For example, a producer in southeastern Florida receives about $3.00 more per hundredweight for milk use in fluid products than a producer in Eau Claire, Wisconsin.

PRICING PROVISIONS ARE OUTDATED

Milk marketing order pricing policies are based on marketing conditions that existed in the 1960's, however, many of those conditions have changed. Initially, the grade A differential was created to provide farmers with financial incentives to produce grade A milk. However, the current grade A differential of $1.04 is far higher than the added cost of producing grade A milk–estimated to be no more than 15 cents per cwt , according to a 1986 study. Further, over 90 percent of all milk produced in this country is grade A, far more than is needed for fluid milk markets. About 42 percent of grade A milk is used for fluid consumption. The remaining 58 percent is used for manufactured dairy products like cheese, nonfat dry milk and ice cream.

Additionally, the distance differential has produced a regional price structure that in some cases bears no relationship to regional variations in the cost of production or to the cost of obtaining supplies from alternative sources. The distance differential was established to make it profitable for surplus milk-producing areas like the Upper Midwest to ship milk to deficit milk-producing areas if necessary. Since that time, however, the distance differential has served as an incentive for some of the areas of historically insufficient milk production to increase their production capacity. Some of these areas have now become surplus milk-producing areas.

These pricing provisions have contributed to increases in production in certain areas of the country, sometimes at the expense of other areas. Traditionally, the Upper Midwest and the Northeast have been the major milk-producing areas. Since the late 1960's, there has been a significant trend toward increased production in all areas of the United States but predominantly in the Northwest, Southwest, and Southern Plains. Although population increases and lower production costs have provided incentives for increasing production in these regions, higher distance differentials in these regions have contributed to increased profitability and thereby increased production and, at times, surpluses. On occasions, this increased profitability is at the expense of other regions. For example,

this incentive has resulted in increased production in the Southwest, where lower production costs already provide an incentive to produce. According to dairy industry sources, southwestern producers sometime transport surplus milk as far as the Upper Midwest to find dairy plants with available processing capacity because processing plants are either operating at full capacity or are not available in the Southwest. As a result, the increased shipments of lower-cost milk to the Upper Midwest processor plants decreases milk prices paid to Upper Midwest producers.

ALTERNATIVES FOR CHANGE

Various alternatives are available for modifying the U. S. dairy program that range from making minor modifications to the distance and grade A differentials to making major revisions to the entire dairy pricing system that includes not only milk marketing orders but the Dairy Price Support program[2] as well. We have recommended the adoption of changes in the dairy programs that would make them more market-oriented, thereby reducing the federal role in the dairy industry. In our 1988 report, we suggested several alternatives for reducing the effects of these provisions. These alternatives included establishing more basing points, modifying or phasing out the grade A and distance differentials, or eliminating the orders entirely, thereby significantly reducing federal regulation of this industry.

A more market-oriented approach would allow the marketplace to more directly influence the price of dairy products. Moving to such an approach, however, involves some careful considerations about how fast such changes can be made while minimizing the adverse impacts on the dairy industry or farm credit institutions. It also needs to consider subsidies provided by competing countries and the extent to which U.S. producers are unfairly impacted by those subsidies.

2Under the federal price support program, USDA stands ready to buy, at designated prices, bulk cheese, butter, and nonfat dry milk that are offered to it for sale.

The administration has recently provided its guidance on the 1995 farm bill that encourage reforms to promote less government involvement. These reforms include revising marketing order authorities to reduce incentives for excessive milk production and to encourage regional competition. This could entail broader scope or flexibility in marketing order authorities to make industry-consensus changes through administrative procedures. Some examples include phasing down the minimum differential for milk used as fluid or revising statutory authority to permit adoption of an alternative order structure, such as multiple basing points.

While we have not evaluated the administration's 1995 Farm Bill guidance, some of the ideas expressed by the administration appear to be consistent with alternatives we have previously discussed and suggested for reducing federal influence on milk pricing.

Mr. Chairman, that concludes my statement. We will be glad to answer your questions.