Order Code IB97011

CRS Issue Brief for Congress
Received through the CRS Web

Dairy Policy Issues

Updated April 9, 2002

Ralph M. Chite
Resources, Science, and Industry Division

Contents

Dairy Policy Issues

Summary

Several major dairy policy issues have captured the attention of the 107th Congress, including: reauthorization of the dairy price support program; the possibility of making counter-cyclical direct government payments available to dairy farmers, in response to volatile farm milk prices; and regional debates over dairy compacts. These issues are expected to be resolved in the context of an omnibus farm bill (H.R. 2646), which is currently in conference committee.

Current authority for the dairy price support program, which supports farm milk prices through USDA purchases of surplus dairy products, was scheduled to expire at the end of 2001. However, a five-month extension, through May 2002, was adopted in the FY2002 agriculture appropriations act (P.L. 107-76). A multi-year extension is under review in the next omnibus farm bill. Both the House-and Senate-passed versions of the farm bill (H.R. 2646) would extend the program at the current level of support of $9.90 per hundredweight (cwt.) — the House version through 2011 and the Senate version through 2006.

In each of the previous three fiscal years (FY1999-2001), Congress has authorized USDA to make ad-hoc direct payments to dairy farmers to help mitigate the effects of volatile farm milk prices. A more permanent counter-cyclical assistance program is being considered in the current omnibus farm bill debate. The Senate-passed version of the farm bill contains a provision that would allow dairy farmers to receive a federal payment over the next three years whenever farm milk prices fall below a certain threshold. In total, $500 million would be available for 12 Northeast states and $1.5 billion for all other states over 3 years. The plan is controversial because of its cost and concerns that an included payment cap benefits small farmers at the expense of large farmers. Two attempts on the Senate floor to strike or replace the provision from the bill were defeated. The House farm bill does not contain a comparable provision.

The New England states had temporary authority for a regional Northeast dairy compact from 1997 until its expiration on September 30, 2001. It allowed the region to establish minimum fluid farm milk prices above the minimum federal level. Many Eastern and Southern dairy farmers support the compact, stating that higher farm milk prices are needed in their regions to allow them to remain solvent. Processors and Upper Midwest producers oppose compacts, saying that they distort dairy markets. Compact supporters have attempted unsuccessfully to attach language to various bills this Congress that would have permanently reauthorized and expanded the Northeast compact and authorized other new compact regions. A counter-cyclical assistance program is viewed by some groups as a potential replacement for dairy compacts.

Many dairy farmer groups support a prohibition on the use of dry milk protein concentrates (MPC) in the production of cheese. Farm groups are concerned that imports of MPC are displacing domestic milk used for cheesemaking and thus depressing farm milk prices. In response, companion bills (S. 847 and H.R. 1786) would impose tariff rate quotas on certain MPCs. Other bills (H.R. 1016 and S. 117) would prohibit the use of dry MPC in domestic cheese production. Dairy processor groups generally are opposed to these bills.

MOST RECENT DEVELOPMENTS

On February 13, 2002, the Senate passed its version of an omnibus 2002 farm bill that will establish federal farm policy for the next several years. The Senate bill was reported as S. 1731, and after floor amendments, was substituted for the text of H.R. 2646, the House-passed version of the bill. Differences between the two measures currently are being worked out in conference committee. Among the farm commodity support provisions in the two versions is an extension of the dairy price support program at the current support price of $9.90 per hundredweight (cwt.) of milk, through 2006 in the Senate-passed bill and 2011 in the House-passed bill. Meanwhile, a provision in the FY2002 agriculture appropriations act (P.L. 107-76, H.R. 2330) temporarily extends authority for the dairy price support program for 5 months through May 2002. A separate controversial provision only in the Senate-passed version of the farm bill would authorize a new, counter-cyclical payment program to supplement dairy farmer income. Federal payments would be given to dairy farmers whenever market prices fall below a certain threshold.

BACKGROUND AND ANALYSIS

Dairy and the 2002 Farm Bill

Conferees currently are considering an omnibus farm bill (H.R. 2646) that is expected to establish federal farm commodity price and income support policy for the next 5 to 10 years. Within both the House- and Senate-passed versions of the pending legislation are provisions for extending the dairy price support program at the current level of support. The Senate version also contains a provision that would authorize counter-cyclical payments to dairy farmers when market prices for farm milk fall below a target level.

Dairy Price Support Program

Background. The Agricultural Act of 1949 established the dairy price support program by permanently requiring the U.S. Department of Agriculture (USDA) to support the farm price of milk. Since 1949, Congress has regularly amended the program, usually in the context of multi-year omnibus farm acts and budget reconciliation acts. Current authority for the dairy price support program is provided by the Federal Agriculture Improvement and Reform Act of 1996 (P.L. 104-127, the 1996 farm bill), as amended. (See Table 1, below, for a recent history of spending on the dairy price support program.)

Historically, the supported market price for milk is intended to protect farmers from price declines that might force them out of business and to protect consumers from seasonal imbalances of supply and demand. USDA's Commodity Credit Corporation (CCC) supports milk prices by its standing offer to purchase surplus nonfat dry milk, cheese, and butter from dairy processors. Government purchases of these storable dairy products indirectly support the market price of milk for all dairy farmers. Prices paid to the processors are set administratively by USDA at a level that should permit them to pay dairy farmers at least the federal support price for their milk.

Table 1. Commodity Credit Corporation Milk Price and Income Support Operations, 1979/80-2001/02

Marketing year[a]	Net Removals Milk Equivalent (billion lbs.)[b]	Net Outlays (million $)	CCC Support Price ($ per cwt.)	CCC Purchases as Percentage of Production
1980-81	12.7	1,975	13.10	9.6
1981-82	13.8	2,239	13.49-13.10	10.2
1982-83	16.6	2,600	13.10	12.0
1983-84	10.4	1,597	13.10-12.60	7.6
1984-85	11.5	2,181	12.60-11.60	8.2
1985-86	12.3	2,420	11.60	8.5
1986-87	5.4	1,238	11.60-11.35	3.8
1987-88	9.7	1,346	11.10-10.60	6.7
1988-89	9.6	712	10.60-11.10	6.7
1989-90	8.4	505	10.60-10.10	5.7
1990-91	10.4	839	10.10	7.0
1991-92	10.1	232	10.10	6.7
1992-93	7.6	253	10.10	5.0
1993-94	4.2	158	10.10	2.8
1994-95	2.9	4	10.10	1.8
1995-96	0.1	-98	10.10-10.35	0.1
1996-97	0.7	67	10.20	0.4
1997-98	0.7	291	10.20-10.05	0.4
1998-99	0.3	480(c)	10.05-9.90	0.2
1999-2000	0.8	684(d)	9.90	0.5
2000-01	0.3	1,140(e)	9.90	0.3
2001-02 (f)	0.2	57	9.90	0.1

Source: U.S. Department of Agriculture, Farm Service Agency, selected publications.
a. The marketing year is October 1-September 30.
b. The milk equivalent is the pounds of fluid milk used to manufacture cheese and butter, on a milkfat basis.
c. Includes $200 million in emergency "market loss" payments authorized by P.L. 105-277.
d. Includes $125 million in net outlays for market loss payments authorized by P.L. 106-78.
e. Includes $675 million in market loss payments authorized by P.L. 106-387.
f. USDA estimate.

The 1996 farm bill (P.L. 104-127) retained the level of support at the then-current price of $10.35 per cwt. for the remainder of 1996, but required it to fall to $10.20 on January 1, 1997, to $10.05 on January 1, 1998, and to $9.90 on January 1, 1999. In order to achieve the support price of $9.90 per cwt. of milk, USDA has a standing offer to processors to purchase surplus manufactured dairy products at the following prices: $0.8548 per lb. for butter, $0.90 for nonfat dry milk, $1.1314 per lb. for block cheddar, and $1.1014 per lb. for barrel cheese. Whenever market prices fall to the support level, processors generally make the business decision of selling surplus product to the government rather than to the marketplace. Consequently, the Government purchase prices usually serve as a floor for the market price, which in turn indirectly support the farm price of milk at $9.90 per cwt.

The 1996 farm bill originally required the dairy price support program to terminate at the end of 1999. However, one-year extensions were authorized through calendar year 2000 in the FY2000 agriculture appropriations act (P.L. 106-78) and through 2001 in the FY2001 agriculture appropriations act (P.L. 106-387). The recently enacted FY2000 agriculture appropriations act (P.L. 107-76, H.R. 2330) contains a further extension of the dairy price support program until May 31, 2002.

2002 Farm Bill Provisions. Both the House- and Senate-passed farm bills (H.R. 2646) contain multi-year extensions of the dairy price support program at the current support price of $9.90 per cwt. The House version provides a 10-year extension of the dairy price support program (as well as for all other major farm commodity support programs) through 2011; the Senate version contains a 5-year program extension of all farm commodity support programs, through 2006. For an overview of major provisions in the pending farm bill, see CRS Report RL31195, *The 2002 Farm Bill: Overview and Status*.

Counter-Cyclical Dairy Farmer Assistance

Background. Over the previous three fiscal years (FY1999-FY2001), Congress provided just over $32.5 billion in emergency spending for USDA programs, primarily to help farmers recover from low farm commodity prices and natural disasters. The majority of these funds were for supplemental direct farm payments made to producers of certain commodities, primarily grains and cotton, but also including soybeans, peanuts, tobacco and milk. Of this amount, dairy farmers received supplemental "market loss" payments of $200 million in FY1999 under the Omnibus Consolidated and Emergency Supplemental Appropriations Act, 1999 (P.L. 105-277), and $125 million under the FY2000 agriculture appropriations act (P.L. 106-78), and $675 million under the emergency provisions in the FY2001 agriculture appropriations act (P.L. 106-387). (See Table 2 below.)

Some dairy farmer groups have sought a permanent direct payment program for dairy farmers to be included in the 2002 farm bill as a means of supplementing dairy farm income when farm milk prices are low. Prior to the emergency payments made each year on an ad-hoc basis in FY1999 through FY2001, dairy farmers generally were not recipients of direct government payments. However, some groups contend that farm milk prices have been volatile in recent years and that dairy farmers need more income stability.

Table 2. Dairy Market Loss Assistance Payments, FY1999-2001

	Amount Available	Payment Rate ($ per cwt. of milk production)	Eligible production (lbs. of milk per farmer)	Maximum payment per farmer
FY1999	$200 million	$0.22	2.6 million	$5,720
FY2000	$125 million	$0.1324	2.6 million	$3,445
FY2001	$675 million	$0.65 (estimated)	3.9 million	Approximately $25,000

2002 Farm Bill Provisions. The Senate-passed version of the 2002 farm bill contains a provision for a counter-cyclical dairy payment program. The proposed program would not replace the dairy price support program and federal milk marketing orders, the current federal milk pricing policy tools. It would serve as an alternative to regional dairy compacts (see "Dairy Compacts" below) and ad-hoc market loss assistance payments to farmers, by authorizing additional federal payments when farm milk prices fall below established target prices.

Under the Senate-passed version, dairy farmers in twelve Northeast states (Maine, New Hampshire, Vermont, Connecticut, Rhode Island, Massachusetts, New York, New Jersey, Pennsylvania, Delaware, Maryland, and West Virginia) would receive a federal payment whenever the minimum monthly market price for farm milk used for fluid consumption falls below $16.94 per hundredweight (cwt.). The payment received by Northeast farmers would be 45% of the difference between the $16.94 target price and the market price. Milk producers in all other states also would be entitled to a federal payment whenever the average farm milk price for a calendar quarter is below the average price for the same quarter during the previous 5 years. The payment rate would be 40% of the difference between the average historical price and the lower market price.

Certain payment limits would be placed on the dairy payment program. The maximum total payments to producers in the Northeast states over the life of the program would be $500 million. The total budget for the other states would be $1.5 billion. For individual producers in all states, payments are limited to the first 8 million lbs. of annual milk production.

The Northeast payment program is modeled after the Northeast dairy compact which had been in effect in the six New England states from 1997 until its expiration on September 30, 2001. However, under the expired dairy compact, dairy processors were required to pay the full difference between the $16.94 fluid milk target price and any market price shortfall. The proposed Northeast program would shift the responsibility of the payment from the processor and ultimately the consumer to the federal government. The current version replaces earlier reported versions of the bill which would have had processors continuing to pay for any price shortfalls in the Northeast. The latest version also would raise the individual payment limit to 8 million lbs. of annual production from an earlier proposal of 6 million lbs. of production.

According to a study conducted by the Food and Agricultural Policy Research Institute (FAPRI) at the University of Missouri, the proposed program would cause an increase in milk production, a rise in fluid milk retail prices, and a decline in fluid milk consumption, and would lower farm milk prices. Overall, average dairy farmer revenue would rise in all 50 states during the three years of the proposed payment program by an average of $0.36 per cwt. in the first two years (FY2002-03) and by $0.14 in the third year (FY2003). According to their estimates, the average revenue benefits would be greater in the smaller dairy production states, mainly because of the 8 million lb. annual production cap on payments. Once the program ends, FAPRI analysis shows an average annual revenue loss of $0.04 per cwt. in all 50 states in FY2005.

The proposed program is generally supported by milk producer groups in the Northeast and the Upper Midwest. Producer groups in the Northeast region view it as an alternative to the Northeast dairy compact. Upper Midwest producers prefer the proposal to state compacts since the proposal shares price premiums nationally. The National Milk Producers Federation, the largest trade group representing dairy producer cooperatives, has expressed concern that the program would be regionally divisive and would pit small-farm states against large-farm states. The International Dairy Foods Association, representing dairy processors, was opposed to the program in its earlier version when processors would have been required to pay the price premiums. However, its opposition was lifted when the funding responsibility was shifted to the federal government in the current proposal.

On December 11, 2001 a Crapo floor amendment (S.Amdt. 2472) to strike the current proposal from the bill was tabled by a vote of 51-47. A Domenici floor amendment that would have replaced the provision with a fixed payment of $0.315 per cwt. of historical milk production regardless of market prices (and with no production limits) was also tabled by a vote of 56-42 on February 13, 2002. The House-passed version of the farm bill does not contain a comparable provision. However, a Sanders amendment, which was somewhat similar in design to the Senate-reported provision, was debated on the House floor and defeated by a 194-224 vote during farm bill floor debate last year.

Dairy Compacts

Background

The 1996 farm bill (P.L. 104-127) gave the Secretary of Agriculture the power to grant the New England states the authority to enter into a regional dairy compact. Under the authorizing statute, this authority was supposed to end at the same time as the adoption of the required consolidation of federal milk marketing orders, which was set in current law as October 1, 1999. However, Congress has granted two extensions of authority, so that the current expiration date is September 30, 2001.

The legislatures of the six New England states agreed to enter into a dairy compact that created an interstate commission with the power to set a minimum price paid by dairy processors to dairy farmers in the six New England states at a level above the federal minimum price. However, any proposed interstate compact had to be approved by Congress, as required by the interstate commerce clause of the U.S. Constitution.

New England farm groups support the compact because they believe that the minimum milk prices dictated by federal milk pricing policy are not sufficient to cover the cost of producing milk on family-sized farms, thus forcing many dairy farmers out of business. The strongest opponent of the Northeast compact has been Upper Midwest dairy producer groups which maintain that the compact artificially encourages the production of milk within the compact region at the expense of other parts of the country that have lower production costs and can sell at lower prices. In addition, opponents maintain that the compact sets a precedent for other regions and industries to protect themselves from competition, an action which critics maintain is anti-consumer and market-distorting.

In late May 1997, New England dairy farmers gave nearly unanimous approval to a compact commission-proposed minimum price of $16.94 per hundredweight (cwt.) for farm milk used for fluid consumption (Class I milk) in the compact region. (The $16.94 floor price became effective on July 1, 1997 and currently serves as the floor price for farm milk used for fluid consumption in the Northeast compact region.

Following the creation of the Northeast compact, many other states expressed interest in either joining the Northeast compact or forming a new, separate compact in the South and other regions. Current law allows New York, Pennsylvania, New Jersey, Delaware, and Maryland to join the Northeast compact as long as their membership is approved by their respective state legislatures and by the Congress. All five state legislatures have approved membership; congressional approval is pending. Fourteen other states, mainly in the South, have approved membership of their states in a new Southern dairy compact, which is also awaiting congressional approval.

Proposed Compact Extension and New Compact Regions

The 1996 farm bill (P.L. 104-127) required the Northeast dairy compact to terminate upon implementation of federal milk marketing order reforms. P.L. 104-127 mandated an April 4, 1999 deadline date for these reforms. However, a provision in the Omnibus Consolidated and Emergency Appropriations Act, 1999 (P.L. 105-277) extended the deadline date for reform to October 1, 1999, which in effect extended the life of the dairy compact until that date. A provision in dairy legislation (H.R. 3428) that was enacted as part of the FY2000 consolidated appropriations act (P.L. 106-113, H.R. 3194) extended authority for the Northeast dairy compact for 2 years until September 30, 2001. The measure did not address the extension of membership in the compact to the five states (New York, New Jersey, Pennsylvania, Delaware and Maryland), which have approved membership in the compact at the state legislature level. Congressional approval is required before these states can join the Northeast compact. The Northeast dairy compact officially expired on September 30, 2001. However, supporters of dairy compacts continue to support reauthorization of the Northeast compact and for new compact authority in other regions.

Companion bills (H.R. 1827 and S. 1157) have been introduced in the 107th Congress that would give permanent authority to the Northeast compact. They would also grant congressional approval to the five pending states to join with the New England states in the

Northeast compact. The bills also give authority for the formation of three other dairy compacts, the largest of which would encompass 14 Southern states. The proposed Southern dairy compact would include Alabama, Arkansas, Georgia, Kansas, Kentucky, Louisiana, Mississippi, Missouri, North Carolina, Oklahoma, South Carolina, Tennessee, Virginia, and West Virginia, all of which already have state legislature approval to become part of a dairy compact. H.R. 1827 and S. 1157 also authorize a Pacific Northwest dairy compact for California, Washington and Oregon, and an Intermountain dairy compact for Colorado, Nevada and Utah. None of these six states' legislatures have approved membership in a compact.

Debate on approval of these compacts in the 107th Congress has proven to be contentious. The text of S. 1157 was offered as an amendment to the Senate version of the FY2001 emergency authorization bill for agriculture (S. 1246). A threatened filibuster by Upper Midwest Senators opposed to compacts led to the withdrawal of the amendment before a vote could be taken. Most recently, similar language was offered as a floor amendment to the House farm bill (H.R. 2646). However, a point of order (which was sustained) was raised against the amendment for not being germane to the bill. (All compacts are under the jurisdiction of the Judiciary Committee, and the farm bill was an Agriculture Committee-originated bill.) A counter-cyclical payment program (as discussed above in this brief) is being considered as a replacement for regional dairy compacts.

Milk Protein Concentrate Trade Issues

Milk protein concentrate is a product in which certain milk proteins necessary for cheese production are selectively included and all or most of the water is removed from the milk, thus making it efficient to ship long distances. Dairy farmer groups, which support a prohibition on the use of dry MPC, are concerned that imports of MPC are displacing domestic milk used for cheesemaking and depressing farm milk prices. Certain concentrations are not covered by tariffs or quotas under the existing World Trade Organization agreement. The importation of these products was not an issue when the agreement was debated in the 1990s.

On March 5, 2001, the General Accounting Office released a study on the production, imports, and regulation of milk protein concentrates. The study found that MPC imports grew rapidly from 1990 to 1999 – from 805 to 44,878 metric tons, including a near doubling in 1999 over 1998 alone. According to the study, six countries (New Zealand, Ireland, Germany, Australia, the Netherlands and Canada) accounted for 95% of the 1999 imports. For the full text of the GAO study, see [http://www.gao.gov/new.items/d01326.pdf].

Currently, neither wet nor dry MPC is allowed as an ingredient in any U.S. cheese which has a standard of identity defined by the Food and Drug Administration, which includes most cheese. Cheese processors had petitioned FDA for a change in standards to allow MPC in cheese production. Conferees deleted from the FY2001 agriculture appropriations bill a Senate provision that would have prohibited FDA from issuing any regulations that would allow MPC as an ingredient in the production of cheese. Companion bills (S. 117 and H.R. 1016) have been introduced in the 107th Congress that would prohibit FDA from allowing milk protein concentrates as an ingredient in any cheese with a standard of identity. Other bills (S. 847 and H.R. 1786) would impose a tariff rate quota on MPC and casein (the major portion of milk protein). Supporters of these bills, including most milk producer groups, contend that foreign MPC and casein is being dumped in the United States. Opponents of the legislation include dairy processor groups, the largest of which is the International Dairy Foods Association, who contend that MPC imports are not displacing U.S. production of nonfat dry milk. They maintain that the domestic support price for nonfat dry milk should be lowered instead to stimulate the market for domestic powder.

The National Milk Producers Federation, the largest trade association representing milk producer cooperatives, is urging the government to examine several trade policy options for addressing the milk protein concentrate import issue. These include provisions in the Trade Act of 1974 that allow the President (following an International Trade Commission investigation) to provide relief to a U.S. industry adversely affected by imports; a 1974 Trade Act provision that allows the U.S. Trade Representative to retaliate against certain foreign trade policies; and the use of antidumping laws and countervailing measures.

Federal Milk Marketing Orders

Background

The farm price of approximately three-fourths of the nation's fluid milk is regulated under federal milk marketing orders. Federal orders, which are administered by the U.S. Department of Agriculture (USDA), were instituted in the 1930s to promote orderly marketing conditions by, among other things, applying a uniform system of classified pricing throughout the market. Unlike the dairy price support program (see "Dairy Price Support Program," above), federal milk marketing orders are permanently authorized and therefore do not require periodic reauthorization. Some states, California for example, have their own state milk marketing regulations instead of federal rules. Producers in federal marketing order regions are affected by two fundamental marketing order provisions: the classified pricing of milk according to its end use, and the pooling of receipts to pay all farmers a blend price.

Proponents of federal orders argue that orders are necessary because dairy farmers have a competitive disadvantage vis-a-vis dairy handlers (processors) when it comes to determining prices that farmers receive for their raw milk. Federal orders regulate handlers who sell milk or milk products within an order region by requiring them to pay not less than an established minimum price for the Grade A milk they purchase from dairy producers, depending on how the milk is used. This classified pricing system requires handlers to pay a higher price for milk used for fluid consumption (Class I) than for milk used in manufactured dairy products such as yogurt, ice cream, and sour cream (Class II products), cheese (Class III), and butter and nonfat dry milk (Class IV products).

Blend pricing allows all dairy farmers in the order region to pool their milk receipts and then be paid a single price for all milk based on order-wide usage (a weighted average of the four usage classes). Paying all farmers a single blend price is seen as an equitable way of sharing revenues for identical milk directed to both the higher-valued fluid market and the lower-valued manufacturing market.

Manufactured class (Class II, III and IV) prices generally are the same in all orders nationwide and are calculated monthly by USDA based on current market conditions. The Class I price for milk used for fluid consumption varies from area to area and in recent years has been a source of regional controversy. Class I prices are determined by adding to a monthly base price, a "Class I differential" that generally rises with the geographical distance from the Upper Midwest, traditionally a milk surplus region.

Class I differential pricing is a mechanism designed to ensure that local farmers receive a guaranteed minimum price for their fluid milk that generally is high enough to encourage adequate production. Local dairy farmers are protected by the minimum price rule against lower-priced milk that might otherwise be hauled into their region. Although a primary goal of federal milk marketing orders is to facilitate the flow of milk from surplus production regions to deficit regions, some dairy producer groups contend that federal order pricing policy actually discourages such movement of milk.

In recent years, producers in the Upper Midwest (Wisconsin and Minnesota) have maintained that federal orders are in need of reform, while many dairy processors contend that orders are market-distorting and should be gradually eliminated. These critics contend that the Class I differentials in some regions are too high and encourage milk production in higher cost of production regions (particularly the Northeast and Southeast) at the expense of traditional dairy states such as Minnesota and Wisconsin. As a result, they say, these regions are becoming less dependent on the Upper Midwest for supplemental supplies in the short production months. Since processors must pay as much for milk shipped in from surplus regions as they would for local production, the critics maintain that there is no economic incentive to bring in milk from other regions, even if that region has a lower cost of production.

Milk producer groups in the Northeast and Southeast generally support the current order system and want Class I differentials to remain no lower than their current levels. Eastern producers contend that any reduction in Class I differentials would reduce their incomes and force smaller farmers out of business. In fact, many Northeast and Southeast producers argue that Class I differentials are not high enough, which led to the formation of the Northeast Dairy Compact and a proposal for a Southern compact, to mandate fluid milk prices that are higher than the minimum federally mandated level. (See "Dairy Compacts," above, for more information on the Northeast and Southern dairy compacts.)

Legislative and Regulatory Modifications to Milk Marketing Orders

Background and Summary of Action. Although Upper Midwest farm groups sought legislative changes to the federal order pricing system in the first half of the 1990s, the lack of consensus among regions precluded any mandated changes to federal orders in the omnibus 1996 farm bill. However the 1996 farm law (P.L. 104-127) did require USDA to reduce the number of milk marketing orders — to at least 10 but no more than 14 from the current 31 orders — and originally gave USDA until April 4, 1999 to administratively achieve this goal. (The deadline date was extended until October 1, 1999 by the FY1999 omnibus appropriations act (P.L. 105-277). When USDA released its final decision on March 31, 1999, it not only proposed a consolidation of orders from 31 to 11, but also proposed comprehensive changes to milk pricing policy by revising how Class I (fluid) milk should be priced and devising a substitute for the basic formula price for farm milk. The text of the final decision can be found in the *Federal Register* of April 2, 1999, or on the USDA website at [http://www.ams.usda.gov/fmor/].

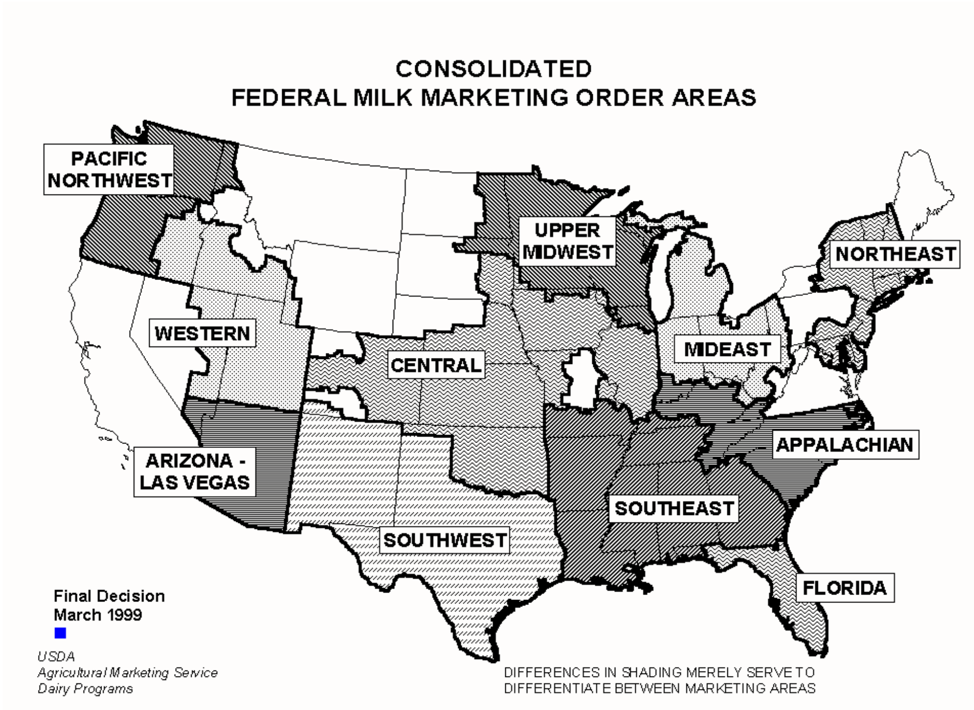
The final decision had to be approved by two-thirds of voting farmers in each of the consolidated regions before it could become effective, which farmers did in all of the consolidated regions in early August 1999. If farmers had rejected the final decision, it would have meant the end of federal milk marketing order regulation in that region. Once the final decision was approved by farmers, it was published in the *Federal Register* and became a final order or rule, which USDA planned to implement on the statutory implementation date of October 1, 1999. However, a legal challenge posed by Northeast dairy farmers and affirmed by a Vermont federal district court temporarily postponed the implementation of a final decision.

Following the legal challenge, Congress agreed to legislation (H.R. 3428) as part of the FY2000 consolidated appropriations bill (P.L. 106-113, H.R. 3194) which was signed into law on November 30, 1999. It required USDA to implement an alternative option (1A) that maintains minimum prices for fluid-use farm milk close to their current levels. (See "Legislative Action to Mandate Option 1A," below, for more information.)

Required Consolidation of Orders. USDA's final decision reduced the number of marketing orders from 31 to 11 orders, effective January 1, 2000 (see map). In considering what regions should be combined, USDA said it looked for overlapping areas of milk supply and considered whether the proposed merged regions have other common features, such as the types of manufactured products produced.

The consolidated region into which a current order was merged was important to producers in that order because of the way farm milk is priced. In general, under federal order blend pricing, the more milk that is used for fluid consumption (Class I use) in an order, the higher that order region's average farm (blend) price will be. Therefore, if Order A, for example, is consolidated with other orders that have a lower Class I utilization rate than Order A, then Order A's blend price will fall when it is consolidated. Likewise, if Order A is consolidated with regions with a higher Class I use than Order A, then farmers in Order A will have a higher blend price when consolidated.

Currently, California, the largest dairy producing state, has a state milk marketing order that is separate from federal orders. The 1996 farm bill allowed California to have its own federal order if California dairy producers petitioned for and approved such an order. As amended by the FY1999 Omnibus Appropriations Act, current law gave California until October 1, 1999 to become a federal order if the state wanted to also retain its quota system. Under California's quota system, each farmer is assigned a quota for production and receives one price for production within quota and a lower price for production above quota. California continues to maintain its own state marketing order and remains separate from the federal order system.



Unshaded regions or states are not federally regulated.

Legislative Action to Mandate Option 1A. The most controversial portion of order reform was in establishing the level of Class I differentials within each of the consolidated orders. Class I differentials are what is added to the base price of milk in a region to determine the minimum price processors must pay for milk used for fluid consumption. USDA's differential pricing structure is based on the "location value" of milk — that is, calculating how far a milk consumption region is from a milk production region, and establishing a minimum price that will attract sufficient milk to the market. This system has been in operation for many years and, prior to the recent reforms, was based on the premise that the Upper Midwest is the only surplus production region in the country. Upper Midwest producer groups have long sought a revision of differentials saying that the level of differentials encourage local production in many regions of the country at the expense of milk produced in the Upper Midwest.

When USDA issued its proposed rule in 1998, it offered two options. Option 1B, USDA's preferred option, would have reduced Class I differentials in many regions, which the Department said would make farm milk pricing more market-oriented. USDA also offered an Option 1A which would keep the Class I differentials at close to current levels. Option 1A was identified by USDA as being the most like the current pricing structure, except for some adjustments to reflect that there is more than one surplus market. Option 1B would result in lower Class I differentials for many regions, because this option recognizes that there are closer markets than in Option 1A from which milk can be drawn when supplies are low.

On November 29, 1999, the President signed into law the FY2000 consolidated appropriations act (P.L. 106-113, H.R. 3194) that among many provisions required USDA to implement Option 1A as part of its final decision.[1] This provision was widely supported by dairy farmer groups in most regions outside of the Upper Midwest. Upper Midwest dairy farm groups, dairy processors, and consumer groups generally supported USDA's final decision (modified Option 1B) and strongly opposed a legislative mandate for Option 1A. An attempt by Upper Midwest Senators to filibuster the measure failed on a cloture motion that was approved 87-9 on November 19, 1999. Although the Administration opposed a legislative mandate for Option 1A, the President signed the measure, since the dairy provisions were one component of a wide-ranging budget agreement between congressional leaders and the Administration on FY2000 spending and other matters. As a result, USDA was required to adopt Option 1A as part of its final decision and to implement the revised final rule, without a comment period or another farmer referendum, on January 1, 2000. (See Table 3 below.)

Base Pricing. USDA's final decision also included a replacement for the basic formula price (BFP), which had served for many years as the base price for all milk prices under the federal order system. The BFP was based on market prices paid by processors for unregulated Grade B milk in the Upper Midwest (U-M), updated by monthly changes in prices for manufactured dairy products, particularly cheese. The BFP had served as the Class III price, or the minimum price for all farm milk used for storable manufactured dairy products (butter, cheese, and nonfat dry milk), and the base price for milk used in Class II (other manufactured) products and Class I (fluid) milk. Since the amount of Grade B production has dwindled significantly over the years, USDA sought an alternative pricing measure that reflects changes in market supply and demand.

USDA's adopted final rule contained a four-class pricing plan that establishes a Class III price for cheese and a separate Class IV price for milk used for butter and powdered milk. Each of these two class prices is now computed based on the value of the components going into the production of these products. For example, the Class III cheese price is based on the value of protein, butterfat and lactose, the principal components of cheese. This method recognizes that the butter/powder market and the cheese market are two distinct markets and therefore should be priced separately.

Under the order system prior to implementation of the final rule, the minimum price paid by processors for milk used for fluid consumption (Class I) each month was equal to the basic formula price plus the regional Class I differential. The final decision continues the method of adding the Class I differential to a base price. However, the base price under the new system is now based on the higher of the Class III (milk used for cheese) or Class IV (milk used for butter/powder) price in each month. Under the old pricing system, the direction of farm milk prices was heavily dependent on the direction of prices in the cheese market. The newly implemented method of using the higher of the Class III or Class IV price means that

---

[1] H.R. 3194 (P.L. 106-113) was a consolidation of the five appropriations bills for FY2000 that were not yet enacted as of early November 1999, and several other authorizing measures. Section 1000(a)(8) of H.R. 3194 provides that upon enactment of H.R. 3194, all language in H.R. 3428 is to be considered enacted as well. H.R. 3428 contains provisions which mandated Option 1A and extended authority for the Northeast dairy compact, among other dairy provisions.

if butter/powder prices are strong while cheese prices are weak, as they have been in recent months, the farm price of fluid milk (Class I) will not be as adversely affected as it was under the old system.

Table 3. Comparison of Pre-Reform Class I Differentials to USDA's Preferred Modified Option 1B, and Option 1A As Mandated by Legislation, Grouped by Pre-Consolidated Order Regions

Dollars per hundredweight ($ per cwt.)

Order Region	1999 Differential	Modified Option 1B	Mandated Option 1A	Order Region	1999 Differential	Modified Option 1B	Mandated Option 1A
NORTHEAST				**UPPER MIDWEST**			
New England	3.24	2.75	3.25	Chicago Regional	1.40	1.95	1.80
NY-NJ.	3.14	2.50	3.15	Upper Midwest	1.20	1.60	1.70
Middle Atlantic	3.09	2.20	3.00	**CENTRAL**			
Unreg. NY & NE	2.54	2.05	2.55	Iowa	1.55	1.95	1.80
APPALACHIAN				Neb.-W. Iowa	1.75	2.00	1.85
Carolina	3.08	2.55	3.10	E. South Dakota	1.50	1.60	1.75
Tennessee Valley	2.77	2.25	2.80	Central Illinois	1.61	2.00	1.80
Louisv-Lex.-Evans.	2.11	1.95	2.20	S. Ill.-E. Missouri	1.92	2.10	2.00
SOUTHEAST	3.08	2.90	3.10	Southwest Plains	2.77	1.95	2.60
FLORIDA				E. Colorado	2.73	1.55	2.55
Upper Florida	3.58	3.80	3.70	W. Colorado	2.00	2.20	2.00
Tampa Bay	3.88	4.20	4.00	Greater Kans. City	1.92	1.90	2.00
Southeast. Fla.	4.18	4.29	4.30	**SOUTHWEST**			
MIDEAST				Texas	3.16	2.10	3.00
Michig-Up. Penin	1.35	1.50	1.80	New Mex-W. Tex.	2.35	1.75	2.25
S. Michigan	1.85	1.85	1.80	**WESTERN**			
E. Ohio-W. PA	2.00	2.00	2.00	SW Idaho-E. Oreg	1.50	1.35	1.60
Ohio Valley	2.04	2.00	2.00	Great Basin	1.90	1.50	1.90
Indiana	1.90	2.00	2.00	**ARIZ-LAS VEG.**	2.52	1.55	2.35
				PACIFIC NW	1.90	1.45	1.90

Source: U.S. Department of Agriculture. *Federal Milk Marketing Order Reform. Regulatory Impact Analysis*, March 1999.

LEGISLATION

H.R. 1016 (Baldwin), S. 117 (Feingold)

Quality Cheese Act of 2001. Prohibits the Food and Drug Administration from making regulatory changes that would allow milk protein concentrates or casein as an ingredient in certain cheeses. H.R. 1016 introduced on March 14, 2001; referred to the House Energy and Commerce Committee on March 14, 2001; referred to the Subcommittee on Health on March 22, 2001. S. 117 introduced and referred to the Senate Agriculture Committee on January 22, 2001.

H.R. 1786 (Obey), S. 847 (Dayton)

Impose tariff rate quotas on certain casein and milk protein concentrates. H.R. 1786 introduced and referred to the House Ways and Means Committee on May 9, 2001. S. 847 introduced and referred to the Senate Finance Committee on May 9, 2001.

H.R. 1827 (Hutchinson), S. 1157 (Specter)

Reauthorizes the consent of Congress to the Northeast Interstate Dairy Compact and grants the consent of Congress to the Southern Dairy Compact, a Pacific Northwest Dairy Compact, and an Intermountain Dairy Compact. H.R. 1827 introduced and referred to the House Judiciary Committee on May 14, 2001. S. 1157 introduced and referred to Senate Judiciary Committee on June 30, 2001.

H.R. 1878 (Kind)

Provides supplemental payments to dairy producers based upon their annual milk marketings. Makes additional payments to dairy producers for any month in which the prices received by producers for milk for the preceding 3 months is less than a target price of $12.50 per hundredweight. Introduced and referred to the House Agriculture Committee on May 16, 2001.

H.R. 2646 (Combest)

Provides for the continuation of agricultural programs through fiscal year 2011. Among this omnibus farm bill's many provisions is a ten-year reauthorization of the dairy price support program through 2011. Introduced and referred to the House Agriculture Committee on July 26, 2001. Reported by the House Agriculture Committee on August 2 (H.Rept. 107-191, part I). Supplemental committee report (part II) filed on August 31. Referred sequentially to the House International Relations Committee, which reported the bill on September 10 (H.Rept. 107-191, part III). Passed the House on October 5, by a vote of 291-120. Received in the Senate on October 9. Conferees appointed February 28, 2002. (See S. 1731 below for action on Senate version of the 2002 farm bill.)

S. 294 (Santorum/Kohl)

National Dairy Farmers Fairness Act of 2001. Authorizes through FY2008 a direct payment program for all dairy farmers. Payments would be made when the fiscal year average Class III farm milk price falls below $12.50 per cwt. Per unit payments would range from 18 to 50 cents per cwt. with the payment rate rising as the price falls. Additional payments of 14 to 34 cents per cwt. would be made to any producer who does not increase annual milk production during the applicable fiscal year. Introduced and referred to the Senate Agriculture Committee on February 8, 2001.

S. 1731 (Harkin)

The Senate Agriculture Committee reported version of the omnibus farm bill. Among its many provisions is a 5-year reauthorization of the dairy price support program and authorization for a counter-cyclical dairy program funded through mandatory contributions made by fluid milk processors and the federal government. Full committee markup of the chairman's mark of the farm bill was completed on November 15, 2001. A revised version of the mark was introduced as S. 1731 on November 27, 2001. Motion to proceed to the consideration of the measure on November 30. Cloture motion on the motion to proceed on November 30. Daschle substitute amendment (S.Amdt. 2471) considered as a complete substitute to S. 1731 on December 10-14, 2001 and December 17-19, 2001. Two cloture motions to S.Amdt. 2471 not invoked by Yea-Nay Votes of 54-43 on December 18 and 19, 2001. Debate resumed February 6-8 and 11-13, 2002, with many amendments adopted. Senate incorporated this measure as a complete substitute to the House-passed bill (H.R. 2646) on February 13, and passed H.R. 2646, as amended on February 13, 2002, by a vote of 58-40. Conferees appointed February 28, 2002.