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# STATE MILK MARKETING ORDER REGULATION AND INTERSTATE DAIRY COMPACTS

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As the dairy industry faces the most comprehensive federal order reform package since the inception of the program, there is new interest in state-level regulation. The Constitution of the United States granted substantial power to the individual states but impediments to the free flow of trade have rarely been tolerated. Compacts between states can be a congressional exception to this most basic precept. This leaflet provides background material on state milk marketing order regulation and interstate dairy compacts.

Given that most milk produced in the United States is already regulated by a federal or state marketing order, one may ask why there is interest in new state orders or interstate compacts. There are at least three reasons for this increased interest.

The first reason for interest is the ongoing change in farm structure. Milk production per cow and the average number of cows per farm have increased steadily for decades, while the total number of cows and dairy farms have declined. As milk production has become more technologically advanced, the resulting cost efficiencies and increased production of milk have exerted downward pressure on the price of milk. Less efficient dairies faced with higher relative costs find that they do not earn adequate returns at competitive prices. In terms of geography, some regions are feeling the effects of this chronic restructuring more than others and are concerned about the impact on rural communities or in some cases the loss of "open space" to development. Milk price enhancement through state orders or compacts is seen as a way to slow structural change in those regions that are concerned about losing farms.

The second reason is the result of reduced government stabilization of prices through the federal dairy price support program. Producers faced a dramatic drop in prices during mid-1997 after record prices in 1996. The overall increase in price volatility over the past decade as the dairy support price has been reduced, has led to producer interest in using regulation to limit price swings, particularly on the downside.

The third reason for interest is the concern with the federal order reform process mandated by the 1996 Farm Bill. The possible negative price implications of federal order changes for producers in some regions are causing a search for other mechanisms to replace or augment federal order pricing regulations.

### *State Milk Marketing Orders*

State intervention in milk pricing through milk marketing orders had its beginnings in the Great Depression of the 1930s. The collapse of milk prices led to the first state order, passed in Wisconsin in 1932, followed closely by New York and several other states in 1933. Federal regulation of milk markets and pricing was also taking place at this time with the passage of the Agricultural Adjustment Act in 1933; and in 1937 the Agricultural Marketing Agreements Act (AMAA) which is the foundation for modern federal milk orders today.

Since the 1930s, approximately three-quarters of the states have attempted some form of state regulation of milk prices at one time or another. At their peak in 1935, state orders operated in 21 states. This number has declined significantly, particularly since the 1960s, as interstate transportation of bulk and packaged milk presented economic and legal problems for state con-

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trol. Challenges to state programs under the Interstate Commerce Clause of the U.S. Constitution often led to subsequent implementation of federal orders. Currently only nine states have active programs--California, Hawaii, Maine, Montana, Nevada, (Western) New York, North Dakota, Pennsylvania and Virginia. Although rarely used, some additional states have emergency authority to set producer prices.

The genesis and goals of the state milk marketing order programs are similar to the federal order program in attempting to regulate the terms of trade through classified pricing and pooling.[1] Past arguments for federal and most state orders have rested in large part on the fact that dairy producers have a highly perishable product and sell to a relatively few processors, resulting in a weak bargaining position. Milk order regulation has been viewed as an attempt to balance market power in an inherently imperfect market, and provide an "orderly" market for milk and its products.

The focus of market order regulation, state and federal, is primarily on regulating the price paid for fluid beverage milk (class I). Generally, class prices paid for milk used for manufacturing purposes (cheese, butter, etc.) may be regulated, but at significantly lower levels than class I prices. The revenue from the different classes of use are then combined or "pooled" and a minimum weighted average value or "blend" price is paid to producers or their cooperative. Class I fluid milk, rather than milk for manufacturing uses, has been the focus of most states and the federal government due to: a) consumer demand for fluid milk has been regarded as less price sensitive ("price inelastic") than demand for many manufactured dairy products, b) higher costs of servicing fluid markets by balancing fluctuations in demand and supply, c) the need to allow manufacturers to clear local markets and compete with manufacturers that may be unregulated, and d) greater ability to control milk and ingredient prices for fluid use that historically have tended to be more local in character with strictly regulated standards and labeling.

State milk marketing orders are actually legal documents that establish the terms of trade between producers and processors within a state or a certain region of a state. Typically enabling legislation is first passed, then administrative rulemaking bodies generally hold hearings to determine specific regulations. Often a producer referendum is held before implementing or amending the regulations.

State orders that have remained viable in retaining their farm milk pricing orders have had some or all of the following characteristics: relative geographic isolation, economically consistent class I price alignment with nearby markets, fluid wholesale/retail price regulation coupled with farm price regulation, and producer quota programs to limit distribution of class I proceeds.

California has the largest state order program. It has been able to retain its program as a result of most of the mechanisms described above. It has generally priced milk at or below surrounding federal order markets. It briefly increased class I prices above surrounding markets in 1993 but revised its formulas downward in 1997 after competitive problems developed. Pennsylvania, on the other hand, does not have a geographically isolated market but sets higher farm milk prices then uses wholesale and retail price control to help prevent the lower cost packaged milk from out-of-state processors from undercutting Pennsylvania prices. Western New York used control of distribution through restrictive licensing to help maintain a state regulated class I price of up to $1.00 per cwt. above surrounding federal markets for many years. However, when the state abandoned restrictive licensing after an adverse court decision in the late 1980s, the state order had to quickly reduce prices and has relied on virtually identical pricing with surrounding federal orders to avoid legal and competitive challenges. Although fairly isolated, Montana found it needed to reduce its class I price to maintain its state program under the threat of losing markets to out-of-state competition.

As mentioned earlier, there has been new interest on the part of some states to unilaterally pass laws or regulations to implement "over-order" pricing on top of existing federal order class I prices. Recently, there has been interest in Michigan to replace a cooperative over-order premium structure which collapsed, with a state mandated pricing regulation. Several recent attempts to impose such prices have failed. New York and Minnesota are two examples where setting higher state regulated prices brought about lawsuits and/or competitive problems for in-state processors and in-state produced milk. Attempts at other ways to regulate out-of-state milk have met with mixed success. An attempt to place

[1]Many states also enacted additional "marketing" regulations, including wholesale and retail price controls, geographic distribution licenses, competitive ("fair trade") practice requirements, and producer payment security programs. With the exception of producer security, many states have reduced or eliminated their role in these dairy marketing regulations.

a tax on all packaged milk (including that from out-of-state) in Massachusetts with the revenue returned to in-state producers, was struck down by the courts. In 1997, California implemented a state regulation to apply a payment obligation by in-state milk processors to the California pool when purchasing out-of-state farm milk in addition to their in-state farm milk pool obligation. This regulation has been challenged by out-of-state producers but has survived a motion for a preliminary injunction against it; however, a final ruling by the court on the interstate commerce question has not yet been reached.

The simple fact is that states are extremely limited in their power to restrain interstate trade and, consequently, states have limited pricing capability.

***Interstate Dairy Compacts:***

The discontent with current federal order price levels and the difficulties of state action to unilaterally raise prices above surrounding areas and regulate interstate commerce, led a group of northeastern states to develop an interstate dairy compact. Compacts are agreements between two or more states to regulate some area of commerce. The authorization to form a compact is found in the U.S. Constitution (Article I, Sec. 10). They have been used in cases of boundary disputes, the control and use of waterways and bridges, penal jurisdiction, utility regulation and to allocate surface water supplies among several western states. Interstate compacts must be approved in identical form by each state which is party to the agreement and then by Congress. Interstate compacts can regulate commerce between the states that are in a compact. However, the ability of a compact to regulate milk between the compact states and states that are outside a compact is an issue which is currently being litigated in the Northeast.

The Northeast Dairy Compact was authorized by six New England states (Mass., Vt., N.H., Me., R.I., Conn.) in the late 1980s and early 1990s. It had been unsuccessfully introduced in the U.S. Senate and House in 1994 and 1995. However, the 1996 Farm Bill provided a vehicle for passage. The 1996 Farm Bill included some restrictions on the Northeast Compact. These restrictions include:

1) The Secretary of Agriculture was authorized to approve the Northeast Compact only after a finding that there was a compelling public interest.
2) The Compact may not regulate class II, III, or IIIa prices (manufacturing uses).
3) The Compact terminates with the implementation of federal milk order reforms (April 1999).
4) An additional six states may join provided they are contiguous to the compact region and upon approval by the state and by Congress.
5) Compensation to USDA must be paid by the Northeast Compact Commission for the cost of surplus purchases under the dairy support program caused by milk production increases in the Compact region that exceed the national average for the fiscal year as determined by the Secretary of Agriculture.
6) The Northeast Interstate Compact shall not prohibit or in any way limit the marketing in the Compact region of milk from any other region. The Compact shall not use compensatory payments as a trade barrier, however, establishment of a compact over-order price does not itself constitute a compensatory payment.

The Secretary of Agriculture subsequently made a finding of "compelling public interest" based on arguments that the increased milk prices would help small family farms. He mandated that the Compact use its authority to offset the increased costs to the Women, Infant and Children (WIC) program.

The Compact Commission, made up of state representatives (including dairy producers and public members), held a hearing to establish a class I price level and other marketing regulations and then conducted a producer referendum. Commission voting is based on one-state, one-vote rule. Pricing decisions are made by a two thirds vote. Funding for the administration of the compact comes from assessments on class I milk sales in the region at a rate of $.032/cwt.

The Northeast Dairy Compact began pricing milk in July 1997. The compact class I price was fixed at $16.94 (Boston) initially for six months and was subsequently extended to stay at that level through the remainder of its authority (April 1999). The price level chosen by the commission gave consideration to costs of milk production in New England and is the average 1991 federal order class I price in New England, adjusted for inflation.

The difference between the compact class I price and the federal order class I price is the compact "over-order differential." Figure 1 below shows that as the federal class I price (driven by the BFP) increased during the fall of 1997, the compact class I over-order differential fell. The compact class I differentials rose again, however, as the federal order class I price dropped during the spring of 1998.

Figure 2 shows that as the size of the compact class I differential rises and falls, the size of the producer compact premium also rises and falls. The compact premium paid to farmers has been based on a utilization of between 40% and 50% class I usage in the market. Therefore the producer premium is typically a little less than half of the class I compact over-order differential. Figure 2 also indicates that the combined federal order and compact producer prices are more stable than the federal order blend price alone. Should federal order class I prices ever exceed the compact class I price, the federal order price would become the effective price. The average compact class I differential between July 1997 and June 1998 was $1.40/cwt. The average producer compact premium was $0.61/cwt.

The Northeast Dairy Compact has faced legal challenges. A lawsuit to challenge the Secretary of Agriculture's authority to approve a compact was unsuccessful. In a separate action, a group of processors primarily located or procuring milk from outside the compact area are currently challenging the compact provisions to price milk produced outside the compact area and sold into the area. Due to the critical importance of equal raw product cost among competitive bottlers, this case is expected to determine whether the Northeast Compact, and other compacts, can be viable in pricing milk above surrounding non-compact areas.

The Northeast Compact Commission also has had to deduct revenue from the compact pool to escrow funds for reimbursement of CCC support program costs due to milk production increases in the compact area. It has also had to exempt school milk sales from payment of compact prices. Both actions have reduced producer compact premiums.

Figure 1. Federal Order Class I and Compact "Over Order" Differential (Price Paid by Class I Handlers)

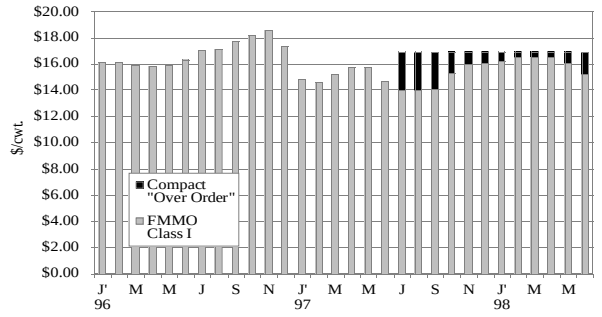
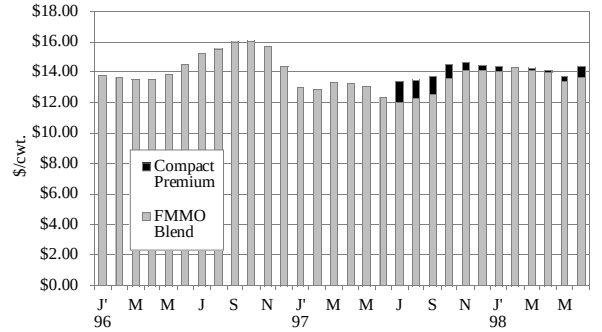



Figure 2. Federal Order Producer Blend Price and Compact "Premium" (Price Received by Producers)




### *Issues and Implications of State Regulation and Compacts*

States have had an advantage as compared to federal programs in that they can be more responsive to local concerns than the federal government. Legislation and/or administrative rules are often more quickly changed, and states typically have more uniform economic interests. However the states' greatest advantage has often been their downfall. States have gotten into trouble legally, politically and/or economically when they have been pressured to raise prices without sufficient concern for price coordination and competition from other areas.

If current litigation upholds the pricing authority of the Northeast Compact, compacts in the future would appear to offer greater ability to regulate milk coming into compact markets and therefore to raise relative prices. They can coordinate prices within broader regions than that which states alone can regulate. Compacts require more "upfront" time to pass enabling legislation in each state and in Congress than individual states alone, but once in place, administratively appear to operate on a faster timetable than federal orders in making changes to regulations. However, they are inferior to federal orders in that the compact borders depend on individual state legislative politics and state lines, rather than market-based regulatory evaluation of fluid product distribution and milk procurement areas.

Consumer Issues - Consumer prices are impacted by state orders and compacts that try to enhance farm price, although the extent is a contentious issue between producer advocates of pricing regulations and consumer advocates that oppose them. The average class I increase in the Northeast Compact from July 1997 through June 1998 was $1.40 per hundredweight or about $0.12 per gallon. If the increase was passed through to the retail level on a penny-for-penny basis, it would translate to about $2.80 per person, per year if calculated using average per capita milk consumption. Obviously this amount is small as a percentage of the average family's disposable income but it would represent a larger percentage of income for poorer families or those with more children. Any analysis of specific retail price impacts is made more difficult by the fact that consideration must be given to any changes in cooperative premium charges, retail mark-ups and a host of other possible factors. The possible positive effects on retail manufactured dairy product prices should also be considered.

There has been some past research that has shown price "asymmetry" between the farm and retail price levels. This research has generally shown that farm milk price increases are more fully and quickly reflected at the retail level than farm milk price decreases. Compact proponents argue that price stability will tend to reduce retail price levels by eliminating this "ratchet" effect. This issue is far from resolved and more analysis is needed. However, it must be questioned whether the positive effects of class I price stability on retail prices (if there are any) could be significant enough to offset the possibly higher average class I milk costs set by a compact.

The issue of maintaining a local milk supply to minimize transportation costs and enhance the "freshness" and shelf-life of milk has been used by compact proponents as a justification for higher regional class I prices. However, today's dairy industry has evolved to the point where farm milk cooling, quality control, transport and plant processing technology make long distance competition not only feasible, but a fact of life. A recent study at Cornell University[2] shows that regional differences between class I prices appear to be in many cases already adequately provided for by class I location value differences in place under current federal orders.

Producer Issues - It is important that measurement of producer benefits take into consideration the impact on pre-existing market premiums and the longer run potential impacts on production and consumption. While producer prices can be initially boosted through class I price enhancement, longer-run impacts on producer pool returns and market premiums will likely show some dilution of benefits as milk production is stimulated and fluid consumption reduced. The current Northeast Compact contains authorization language that could allow for producer payment that is restricted to an individual farm's production history or base at time the compact took effect. This could remove some of the incentive to expand production, but "quota" or "two-tier" pricing has been controversial among producers in the past. If a significant number of states start or join compacts, the stimulation of milk production may be sufficient to lower national manufacturing milk prices, with the milk producers in non-compact or primarily manufactured dairy product markets being most negatively impacted. Ultimately the increased use of state orders and compacts for price enhancement will not only be regionally divisive within the U.S., but may also be seen as trade distorting by our international trading partners.

Compacts seeking to increase producer prices above existing levels may face the issue of revenue distribution between the states. Of the Northeast Com–pact states, Massachusetts contributes the majority of class I revenues but has very little milk supply. Much of the money generated from Massachusetts consumers goes to Vermont and New York producers. There are clearly incentives for low class I utilization states or producers in those states to attach themselves to higher utilization markets. The potential failure of producers in states surrounding compact areas to gain access to the compact pool or enact a compact of their own will be a source of increased frustration and competitive inequity among producers.

Processor Issues - Processor impacts will vary. Fluid processors have typically been concerned about reductions in sales if raw milk prices increase due to regulation. There may be advantages to some processors in achieving more uniform raw product costs. However, achieving equal raw product costs can be elusive. For this reason regulatory change may create anxiety on the part of processors. It may even disrupt pre-existing producer-processor contractual relationships. Furthermore, processors and cooperatives in bordering states can face problems in losing producers who want to market milk through handlers with access

[2]Research Bulletin 98-05, *Normative Estimates of Class I Prices Across U.S. Milk Markets*, James E. Pratt, P.Bishop, E. Erba, A. Novakovic, M. Stephenson, Department of Agricultural Resource and Managerial Economics, Cornell University.

to the compact pool, or face paying premiums to keep them. Such premiums will probably not be equal for all the competing handlers (or producers) in the bordering milkshed.

The processor beneficiaries of class I price enhancement are more clearly the manufacturers (e.g. cheese, butter, nonfat dry milk) in the state order or compact area. To the extent that higher pooled producer returns are provided to all milk producers (not just to the producers shipping to class I processors), the stimulation of local milk production may make milk more available and possibly lower their milk costs.

Public Policy Issues - As was discussed at the outset of this leaflet, three major concerns have given rise to the interest in compacts and state order pricing initiatives: rapid changes in farm structure and regional production shifts, increased milk price volatility, and potential producer price reductions resulting from federal order reform.

Questions have been raised by compact opponents regarding the use of milk price enhancement to preserve current dairy farm structure and rural economies, and the regressive incidence of such a pricing policy on consumers. Other "non-price" policies such as tax relief and/or other input cost assistance targeted to certain producers or geographic areas would reduce market distortions. However, such policies also require funding, which may be more difficult to enact politically, particularly as producers who do not qualify for the targeted benefits will likely oppose them. Given the strong trend towards larger and fewer farms along with regional shifts in production, slowing structural change with any of the policy tools available may have limited success.

Compacts can reduce price volatility but are a less than perfect substitute for the loss of the support program, given that class I use (for which prices are stabilized) is less than 50% of the milk price income for most producers outside of the Southeast. If compacts or states seek to set fixed or stabilized class I prices at the top of historical price ranges, it also begs the question of whether price enhancement, rather than price stability, is really the goal. Greater energy to develop other tools such as futures markets, forward contracting, and insurance, could allow producers to manage cash flow and limit price risk without the controversy associated with state orders and compacts.

If producer groups and policymakers see state orders and compacts as simply replacing income lost by the potential reduction in prices under federal order reform, milk consumption and production would not be expected to change as they would if prices were increased. However, it must be kept in mind that even with this limited goal that states, and probably compacts, cannot coordinate prices between and or even within milk markets as effectively as current federal orders. It can be argued that moving from a national system of prices, to a patchwork of state and regional pricing programs, will lead to greater regulatory, and consequently market, instability. Not only will development of a national dairy policy be made more difficult, but if industry support and political focus shifts from federal orders to state orders and compacts, it is very possible that neither will survive in the long-run.

***Conclusions***

Regulatory developments in the dairy industry remind policy experts of a concept referred to as regulatory cycles. Back in the 1930s, state milk control began as a reaction to disorderly marketing conditions and unequal pricing conditions between processors and producers. However, over time, fewer states had the ability to control prices as the industry evolved, and federal orders replaced most state orders by the 1980s. Could another cycle of state regulation be starting in a reaction to producer dissatisfaction with current federal order prices or potential federal withdrawal from dairy policy? Considering that state regulation has largely been replaced due to the dairy industry becoming, more regional, national and even now international in scope, it may be wise to reflect on past lessons learned.

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