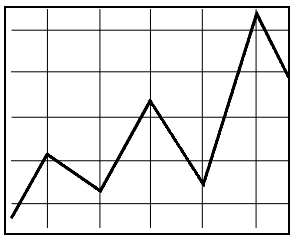
MARKETING AND POLICY BRIEFING PAPER



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CORRECTION AND AMPLIFICATION:
Marketing and Policy Briefing Paper No. 71
Order Reform and Reforming Order Reform

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In Marketing and Policy Briefing Paper No. 71 distributed recently, we outlined and assessed the effects of USDA's Tentative Final Decision amending federal milk marketing orders. These amendments are slated to go into effect on January 1, 2001, pending producer approval, with possible alterations based on comments received by February 5, 2001.[2]

In our discussion of USDA's Tentative Final Decision, we overlooked a key change in Class I pricing and misinterpreted related effects. We offer this addendum to correct our misinterpretation and to provide some additional comments on the decision.

The important Class I pricing change relates to a change in the Class I "mover." Current orders (based on the initial order reform) use the higher of advanced Class III or Class IV skim milk prices as the mover. The Class I skim milk price is the mover plus the Class I differential for the specific order. The Class I price for milk "at test " (3.5 percent butterfat) is 0.965 times the Class I skim milk price plus 3.5 times the Class I butterfat price. The Class I butterfat price is the Class III/IV butterfat price plus the Class I differential divided by 100.

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The Tentative Final Decision establishes the Class I price in a different fashion:

> *The Class I price per hundredweight shall be the adjusted Class I differential…plus the higher of the advanced Class III or advanced Class IV prices…*
>
> *The Class I skim milk price per hundredweight shall be the adjusted Class I differential…plus the advanced Class III or advanced Class IV skim milk price used in the calculation of the higher of the advanced Class III or advanced Class IV prices…*
>
> *The Class I butterfat price per pound shall be the adjusted Class I differential…plus the advanced Class III or advanced Class IV butterfat price used in the calculation of the higher of the advanced Class III or advanced Class IV prices…*

What this means is that the "higher of" will be the higher of advanced Class III or Class IV prices for milk at 3.5 percent butterfat, not advanced skim milk prices. And the relevant Class I skim and butterfat prices will be based on the advanced Class III or Class IV skim and butterfat prices***, depending on which advanced Class III or IV price (at 3.5 percent butterfat) is highest***.

If the advanced Class III price is higher, then the Class I skim milk price will be the advanced Class III skim milk price (tied to cheese and dry whey prices) plus the Class I differential. The Class I butterfat price will be the Class III butterfat price (tied to cheese prices) plus the Class I differential divided by 100.

If the advanced Class IV price is higher, then the Class I skim milk price will be the advanced Class IV skim milk price (tied to nonfat dry milk prices) plus the Class I differential. The Class I butterfat price will be the Class IV butterfat price (tied to butter prices) plus the Class I differential divided by 100.

We incorrectly assumed that the Class I mover in the amended orders would continue to be the higher of advanced Class III or Class IV skim values. Thus, we incorrectly argued that, with a lower protein price from the revised formula, Class IV would consistently move Class I. That is not necessarily the case. With the 3.5 percent butterfat advanced prices used to compute the mover, whether Class III or Class IV is higher depends on the relative relationship between the prices of butter and cheese as reported by the National Agricultural Statistics Service.

The chart below attempts to illustrate this relative relationship. It shows for ranges of butter and cheese prices whether Class III ("C") or Class IV ("B") will be the Class I mover under the amended orders. In constructing the table, we assumed prices for nonfat dry milk and whey of $1.01 and $0.20 per pound, respectively.

Note from the table that at cheese prices at or below $1.15 per pound, Class IV will be the mover at any butter price above support. At a cheese price of $1.75 or higher, Class III will be the mover at butter prices lat or below $2.00 per pound. At current butter prices of around $1.15 per pound, the cheese price would have to be in the $1.40 range for the advanced Class III price to be the Class I mover. Had the method for establishing a mover been in effect in 2000, the advanced Class IV price would have been mover of Class I every month. The average difference between the advanced Class IV and Class III prices in 2000 (using formulas in the tentative final decision) was $1.80 per hundredweight, ranging from $0.64 (when the NASS 2-week butter price was $0.88 and

	NASS Advanced Cheese Price, $/Lb,											
NASS Advanced Butter Price $/Lb	1.15	1.20	1.25	1.30	1.35	1.40	1.45	1.50	1.60	1.65	1.70	1.75
0.70	B	C	C	C	C	C	C	C	C	C	C	C
0.75	B	C	C	C	C	C	C	C	C	C	C	C
0.80	B	B	C	C	C	C	C	C	C	C	C	C
0.85	B	B	C	C	C	C	C	C	C	C	C	C
0.90	B	B	C	C	C	C	C	C	C	C	C	C
0.95	B	B	B	C	C	C	C	C	C	C	C	C
1.00	B	B	B	C	C	C	C	C	C	C	C	C
1.05	B	B	B	B	C	C	C	C	C	C	C	C
1.10	B	B	B	B	C	C	C	C	C	C	C	C
1.15	B	B	B	B	B	C	C	C	C	C	C	C
1.20	B	B	B	B	B	C	C	C	C	C	C	C
1.25	B	B	B	B	B	B	C	C	C	C	C	C
1.30	B	B	B	B	B	B	C	C	C	C	C	C
1.35	B	B	B	B	B	B	C	C	C	C	C	C
1.40	B	B	B	B	B	B	B	C	C	C	C	C
1.45	B	B	B	B	B	B	B	C	C	C	C	C
1.50	B	B	B	B	B	B	B	B	C	C	C	C
1.55	B	B	B	B	B	B	B	B	C	C	C	C
1.60	B	B	B	B	B	B	B	B	C	C	C	C
1.65	B	B	B	B	B	B	B	B	C	C	C	C
1.70	B	B	B	B	B	B	B	B	B	C	C	C
1.75	B	B	B	B	B	B	B	B	B	C	C	C
1.80	B	B	B	B	B	B	B	B	B	C	C	C
1.85	B	B	B	B	B	B	B	B	B	B	C	C
1.90	B	B	B	B	B	B	B	B	B	B	C	C
1.95	B	B	B	B	B	B	B	B	B	B	B	C
2.00	B	B	B	B	B	B	B	B	B	B	B	C

the cheese price was $1.18) to $3.50 (when the NASS 2-week butter price was $1.20 and the cheese price was $1.03).

The change from using skim milk prices to using 3.5 percent butterfat prices is a major change in Class I pricing. The change could result in very large month-to-month shifts in Class I skim and butterfat values, even though Class III and Class IV prices changed very little. Consider the table below, which shows hypothetical product and milk values for two months over which the butter price increased five cents per pound and cheese, nonfat dry milk, and whey prices did not change. The advanced Class III price at $11.89 is the mover of Class I values in Month 1. In month 2, the Class IV price is the mover at $11.97. The mover price increased 9 cents per hundredweight. But the Class I skim milk value increased by $2.30 per hundredweight and the Class I butterfat price decreased by 61 cents per pound.

	Month 1	*Month 2*
Butter ($/Lb.)	1.10	1.15
Cheese ($/Lb.)	1.35	1.35
NDM ($/Lb.)	1.01	1.01
Whey ($/Lb.)	0.20	0.20
Advanced Class III ($/Cwt.)	11.89	11.89
Advanced Class IV ($/Cwt.)	11.76	11.97
Class I Skim ($/Cwt.)*	5.53	7.83
Class I Butterfat ($/Lb.)**	1.87	1.26

* Base - before adding Class I Differential
**Base - before adding Class I Differential/100

Since the average composition of fluid milk sold at retail is around 2 percent butterfat, abrupt shifts in the Class I mover could cause volatile fluid milk prices. Further, with the butterfat value for Class I being based on the butterfat value of the higher of the 3.5% advanced Class III or Class IV price, this assures a relatively high Class I butterfat value. A higher butterfat value means a lower skim milk value for fluid milk. Fluid milk plants will sell their excess cream to Class IV handlers. Thus, there is an incentive for fluid milk plants to keep butter prices high.

Since the butterfat value in cheese (Class III butterfat value) will be consistently higher than the butterfat value in Class IV, some cheese plants have an incentive to use a cheaper source of butterfat in making cheese, especially processed cheese. These cheaper source of butterfat could either be anhydrous milkfat or cream purchased from California. California bases its butterfat value on the butter price and not cheese.

Further, the producer butterfat price per pound for each order will be a blended butterfat value from Class I, II, III and IV butterfat values. The Class III butterfat value would be

higher than the blended butterfat value for the order. This may serve as an incentive for cheese plants in high Class III utilization markets to de-pool.

A blended butterfat price per pound paid to producers also creates more basis risk when using dairy futures or options to protect milk prices. The futures contract is a Class III 3.5% milk price. But, the producer pay price now is influenced by the blended butterfat price, resulting in less conformance with the traded Class III price.