

Market Situation & Outlook

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After two years of development and ten months of political maneuvering, the reform of Federal Milk Marketing Orders (FMMOs) is finally moving forward. On Monday, November 29th, President Clinton signed into a law the Omnibus Budget Reconciliation Bill, which contained modifications to the Final Rule on federal order reform. Provisions of the Final Rule as amended by the recent legislation are scheduled for implementation on January 1, 2000. The focus of this *ABI Situation & Outlook* is to discuss the changes made to the Final Rule and to determine the impact of its implementation on butterfat values.

Overview of Final Rule – As Amended

Although it literally took an act of Congress to change the Final Rule, there are no structural differences between the Final Rule that was introduced on March 31, 1999 and the reform package that will be implemented next month. The basis of the reform package is still multiple component pricing, fewer milk marketing orders, and survey based commodity prices. These elements represent the foundation of milk marketing reform and have not been changed by the amendments to the Final Rule.

Although other dairy provisions are included in the Omnibus Bill, the only change that Congress made to the Final Rule was to instruct the Secretary of Agriculture to use the higher Option 1A Class I differentials. The national average Class I differential for Option 1A is \$2.61 per hundredweight, or \$0.33 higher than the Option 1B differentials outlined in the Final Rule. Option 1A differentials result in a price surface that closely resembles existing Class I price differences across federal order markets.

In addition to increasing the Class I differentials, Congress has also instructed the Secretary to conduct a formal rulemaking hearing to reconsider the Class III and Class IV milk pricing formulas in the Final Rule. This hearing process was deemed necessary because the existing formulas "do not adequately reflect public comment on the original proposed rule" and the formulas "are sufficiently different from those in the proposed rule." On December 1, 2000 the Secretary is required to publish a final decision on the Class III and IV milk pricing formulas and any subsequent changes in the pricing formulas must be implemented on January 1, 2001. Requiring a national hearing to discuss pricing

Summary of Dairy Policy Changes:

- Option 1A differentials instead of 1B,
- National hearing to review Class III & IV pricing formulas,
- Forward contracting pilot program for all milk except Class I, and
- Extension of the Northeast Dairy Compact.

formulas and mandating the use of Option 1A differentials are the only two policy changes associated with the reform of milk marketing orders. The Omnibus Bill does provide for two other policy changes, but neither is related to order reform.

Along with the changes to the Final Rule, the Agricultural Marketing Agreement Act of 1937 is amended to allow for a dairy forward pricing pilot program. The pilot program would be voluntary and all payments made and received under forward contract would satisfy minimum federal order price obligations. All milk except that milk designated for Class I use is eligible for forward contracting under this pilot program. To determine the impact on producer prices, the Secretary must submit a report to Congress no later than April 30, 2002. The authority to conduct the forward contracting pilot program ends on December 31, 2004.

The last dairy policy initiative contained in the Omnibus Bill involves the Northeast Compact. Based on the 1996 Farm Bill, the authority for the Northeast Dairy Compact would expire with the implementation of federal order reform. With the signing of the Omnibus Bill, the Northeast Dairy Compact is granted a reprieve. Congressional authority for this program is now extended until September 30, 2001.

Final Rule's Affect on Butterfat Values

Because of the industry's increased emphasis on component pricing, price announcements in federal orders will be dramatically different beginning January 1, 2000. The butterfat differential will be discontinued and there will be announced prices for protein, other solids, nonfat solids, and butterfat. Market administrators will still announce per hundredweight prices for selected markets, but these prices will be determined using component values and standard total solids levels in milk.

With this new pricing system, there will be three different butterfat price announcements for any given month. Regardless of how the butterfat is utilized, the same basic pricing formula is used to determine the value of butterfat. This formula is

$$\text{Butterfat Price} = ((\text{Nass AA Butter Price} - 0.114) / .82).$$

Differences in butterfat values will exist across classes of milk because of differentials and number of survey weeks used to determine the average Grade AA butter price. The details of how these prices are determined and when they will be announced are described below.

- **Class I Butterfat Price:** On or before the 23rd of each month, the Class I butterfat price will be announced. This announced price will apply to sales in the following month (e.g., December Class I price announcement will apply to sales in January). This Class I butterfat price will be determined by summing the advanced butterfat price and the Class I differential which is converted to a per pound of milk basis. For the Class I butterfat price, only the two most recent weeks of NASS survey data are used to determine the average Grade AA butter price.

- **Class III & IV Butterfat Price:** The price for butterfat used in Class III and IV products will be the same price. This price will be announced on or before the 5th of each month. This announced price would apply to sales in the preceding month (e.g., February announcement will apply to January sales). This butterfat price is calculated using the formula outlined above. The average Grade AA price is based on all survey weeks in the preceding month, not just the two most recent weeks.

- **Class II Butterfat Price:** With the exception of one slight difference, the value of butterfat used in Class II products is the same as that used in Class III and IV. The only difference is the addition of \$0.007, which represents the Class II differential per pound of milk. Unlike the price for Class II nonfat solids, the value of

Class II butterfat is not announced in advance.

- **Do these Changes Make a Difference?**

Across all classes of milk, the butterfat formulas in the Final Rule result in higher average prices for butterfat when compared to existing market values. The primary reason for this difference is the use of Grade AA butter prices in the Final Rule. With the current market structure, butterfat values are determined by using the CME Grade A price, which is about seven cents less than the NASS survey Grade AA price. Table 1 illustrates the monthly price differences beginning with September 1998 – the first month for which NASS survey prices are available.

Compared to actual market values, the Class I butterfat price associated with the Final Rule averages ¢14.6 higher per pound of fat over the past 14 months. The price difference ranges from ¢83 lower to ¢102 higher (Table 1). These large discrepancies between current and Final Rule prices appear mostly in 1998 when the butter market was extremely volatile. The price difference since January 1999 has narrowed to only ¢6.4 per pound of fat. The average Class I differentials used for this analysis are \$2.58 for the current system and \$2.61 (Option 1A) for the Final Rule.

Although the difference is not as large, the price formulas in the Final Rule also result in higher average butterfat values for the Class II, III, and IV markets. Results of the analysis show that butterfat values averaged ¢6.5 higher for Class II, ¢6.2 higher for Class III, and ¢6.6 higher for Class IV (Table 1). These price differences are relatively stable even when the time period is narrowed to six and ten months.

The results of this analysis clearly indicate that manufacturers will most likely pay higher prices for butterfat across all classes of milk. What remains to be seen is if these higher input costs can be recovered from the retail market. If not, margins may suffer.

Table 1: Comparison of Butterfat Values, Current vs Final Rule

	Current System				Final Rule			Change			
	Class I	Class II	Class III	Class III-A	Class I	Class II	Class III & IV	Class I	Class II	Class III	Class IV
Sep-98	3.3098	3.2870	3.2873	3.3344	2.4788	3.1272	3.1202	-0.8310	-0.1598	-0.1671	-0.2142
Oct	2.8102	2.7874	2.7949	2.8158	3.0478	2.9266	2.9196	0.2377	0.1393	0.1248	0.1039
Nov	1.8945	1.8717	1.8861	1.8664	2.9149	2.2168	2.2098	1.0204	0.3451	0.3237	0.3434
Dec	1.4600	1.4372	1.4472	1.4086	2.4345	1.5220	1.5150	0.9745	0.0848	0.0678	0.1064
Jan-99	1.5163	1.4935	1.4848	1.4533	1.4784	1.5941	1.5871	-0.0379	0.1007	0.1024	0.1339
Feb	1.5406	1.5178	1.4441	1.4692	1.6145	1.4514	1.4444	0.0740	-0.0663	0.0003	-0.0248
Mar	1.4623	1.4395	1.3900	1.3974	1.4672	1.4556	1.4486	0.0049	0.0161	0.0586	0.0512
Apr	1.0453	1.0225	1.0349	1.0274	1.5258	1.1070	1.1000	0.4806	0.0845	0.0651	0.0726
May	1.2132	1.1904	1.1838	1.1874	1.1105	1.1827	1.1757	-0.1027	-0.0076	-0.0081	-0.0117
Jun	1.6976	1.6748	1.6679	1.6866	1.1017	1.6496	1.6426	-0.5959	-0.0252	-0.0253	-0.0439
Jul	1.4315	1.4087	1.4290	1.4168	1.6373	1.5500	1.5430	0.2058	0.1413	0.1140	0.1262
Aug	1.4524	1.4296	1.4703	1.4386	1.5584	1.5366	1.5296	0.1060	0.1070	0.0593	0.0910
Sep	1.3776	1.3548	1.3785	1.3396	1.6198	1.4841	1.4771	0.2422	0.1293	0.0986	0.1375
Oct	1.2452	1.2224	1.1764	1.1793	1.5120	1.2427	1.2357	0.2668	0.0203	0.0593	0.0564
Average	1.6754	1.6526	1.6482	1.6443	1.8215	1.7176	1.7106	0.1461	0.0650	0.0624	0.0663