



# National Milk Producers Federation

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May 1, 2023

Agri-Mark, Inc.  
 Associated Milk Producers Inc.  
 Bongards' Creameries  
 Burnett Dairy Cooperative  
 California Dairies, Inc.  
 Cayuga Marketing Cooperative Milk Producers Association  
 Dairy Farmers of America, Inc.  
 Ellsworth Cooperative Creamery  
 FarmFirst Dairy Cooperative  
 First District Association  
 Foremost Farms USA  
 Land O' Lakes, Inc.  
 Lone Star Milk Producers  
 Maryland & Virginia Milk Producers Cooperative Association  
 Michigan Milk Producers Association  
 Mount Joy Farmers Cooperative Association  
 Northwest Dairy Association  
 Oneida-Madison Milk Producers Cooperative Association  
 Prairie Farms Dairy, Inc.  
 Scioto Cooperative Milk Producers' Association  
 Southeast Milk, Inc.  
 Tillamook County Creamery Association  
 United Dairymen of Arizona  
 Upstate Niagara Cooperative, Inc.

Mr. Bruce Summers  
 Administrator  
 Agricultural Marketing Service  
 United States Department of Agriculture  
 1400 Independence Avenue, SW  
 Washington, D.C. 20250

Re: Request for a national hearing to amend the uniform pricing provisions of all federal milk marketing orders

Dear Administrator Summers:

The National Milk Producers Federation (NMPF) requests a national hearing to amend five pricing provisions under all Federal milk marketing orders. NMPF's comprehensive hearing request is meant to modernize pricing provisions that have mostly not been addressed since the implementation of the Federal Order Reform process on January 1, 2000, more than 23 years ago.

"One of the major purposes of the Agricultural Marketing Agreement Act ["AMAA"] was to create and maintain an orderly market and, in so doing, assure the dairy farmer an adequate minimum price for the milk he delivered to the handlers regardless of how the milk was later used." *Lewes Dairy, Inc. v. Freeman*, 401 F.2d 308, 311 (3d Cir. 1968). With the AMAA, Congress mandated the Secretary of Agriculture ("Secretary") maintain an orderly market for milk to avoid "impair[ing] the purchasing power of farmers and destroy[ing] the value of agricultural assets." 7 U.S.C. §§ 601, 602(1).

NMPF is the voice of America's dairy farmers. Through its constituent 25 cooperative members, NMPF represents two-thirds of the approximately 28,000 commercial dairy farmers in the United States. NMPF's member cooperatives reflect geographic diversity and product mix diversity of the dairy producer and cooperative sectors. The majority of U.S. dairy farms are small businesses, which is defined by United States Department of Agriculture ("USDA" or "Department") as a farmer with \$3.75 million or less in annual gross receipts. For example, in 2022, the average dairy farm sold 8.1 million pounds of milk, for which it received an estimated \$2.3 million. On average, however, most farms are below this size.

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NMPF's member cooperatives process a majority of the Class I milk pooled under Federal orders and distributed on routes within the 11 marketing areas and include one of the largest fluid dairy ESL manufacturers in the United States. NMPF members have significant Class II and Class III manufacturing operations and manufacture a majority of U.S.-produced butter and nonfat dried milk products.

Given the diversity and breadth of its membership, NMPF is the trade association best able to undertake a balanced review of the Federal Order system and to weigh its impacts on both dairy farmers as well as processors and manufacturers. The Federation's proposals are in the best interest of the entire U.S. dairy industry and appropriately balance the economic interests of dairy farmers and dairy plant operators.

This package of proposals was considered and approved unanimously by the NMPF Board of Directors.

The current system of federal order minimum class prices, which has been with us since January 1, 2000, is the hybrid product of Federal Order Reform rulemaking and Congressional action. The dairy product price formulas for determining Federal Order Class III and IV prices adopted in January 2000 replaced the Basic Formula Price (BFP), which continued to use a survey of milk prices, as did the preceding Minnesota-Wisconsin (M-W) price series, as the basic means of price discovery for establishing milk prices to operate the Federal Order program. The basic price discovery mechanism of the BFP was a direct survey of milk prices paid by dairy manufacturing plants. Discontinuing the BFP represented a major change because it replaced this previous system of price discovery with a system that indirectly discovered raw milk prices entirely by calculation from market prices of the products manufactured from that milk. The intricate product price formulas and their constituent coefficients that resulted took on the important function of accurately simulating the market realities of the complex transfer of price discovery from the markets for dairy products to the markets for unprocessed milk used to produce them.

At the same time, the Class I prices that were established by Congress, updated the pre-existing Class I differentials by adopting an optional USDA-suggested price surface, which had been generated on the basis of 1990s milk market conditions, and extended it coast-to-coast. All of the prices and price formulas of Federal Order Reform were premised upon the costs and realities of milk production and dairy product manufacturing which prevailed at that time.

Those market realities have subsequently changed as the U.S. dairy industry has undergone dynamic change since 2000. The critical Federal Order dairy product price formulas and Class I differentials have, for the most part, remained static. For example, the United States currently sells about 18 percent of its milk production as manufactured products in export markets, compared to about 5 percent in 2000 – changing the value of

milk at export locations such as California and other places across the country. Additionally, the location of milk production has changed, transportation costs have increased significantly, and the southeastern states have become progressively more milk deficit. Also, the industry has seen the successful deployment of very large manufacturing plants, capable of processing over 8 million pounds of raw milk a day – and yet many smaller-sized manufacturing plants remain critically important to satisfying the domestic and export demands for the U.S. milk supply.

These realities, and others, necessitate a pricing formula review that incorporates the Class I mover, Class I differentials, manufacturing allowance credits and other factors in the Class price formulas. The constituent parts of those formulas, including the products used, the make allowances, and the yield factors in the component formulas, the assumed composition of producer milk, as well as the Class I differentials, have become increasingly outdated, even when previously updated, to the extent that the effective administration of the federal order program has become increasingly difficult.

NMPF has engaged in a more than year-long comprehensive study of needed updates to all the Federal Order pricing formula provisions.<sup>1</sup> This effort included consideration of mechanisms for making updates in the future as the industry evolves. NMPF has undertaken this important activity with the essential and dedicated assistance of dozens of marketing experts from the staffs of its member cooperative marketing associations. The NMPF Board of Directors unanimously approved the following five recommendations for proposed amendments to all Federal Orders.

**1. Increase make allowances in the component price formulas to the following levels:**

<b>Butter</b>	<b>\$0.21 per pound</b>
<b>Nonfat dry milk</b>	<b>\$0.21 per pound</b>
<b>Cheese</b>	<b>\$0.24 per pound</b>
<b>Dry Whey</b>	<b>\$0.23 per pound</b>

- 2. Discontinue use of barrel cheese in the protein component price formula**
- 3. Return to the “higher-of” Class I mover**
- 4. Update the milk component factors for protein, other solids, and nonfat solids in the Class III and Class IV skim milk price formulas**
- 5. Update the Class I differential pricing surface throughout the United States**

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<sup>1</sup> See 7 C.F.R. §§ 1000.50-52.

Implementation of all five components of NMPF's comprehensive proposal would require amendment of the Federal Order pricing regulations limited to certain of those in § 1000.50-52.

**Proposal 1: Increase the make allowances in the component price formulas**

NMPF requests amendment to the manufacturing cost allowances found in the four basic component price formulas as part of the request to the Secretary to call a hearing pursuant to 7 C.F.R. § 900.1, *et seq.*, to, *inter alia*.

**Amend 7 C.F.R. § 1000.50(l), (m), (n), (o), and (q), applicable to all federal milk marketing orders, to provide:**

**§ 1000.50 Class prices, component prices, and advanced pricing factors.**

\* \* \* \* \*

(l) *Butterfat price*. The butterfat price per pound, rounded to the nearest one-hundredth cent, shall be the U.S. average NASS AA Butter survey price reported by the Department for the month, less ~~17.15~~ **21.00** cents, with the result multiplied by 1.211.

(m) *Nonfat solids price*. The nonfat solids price per pound, rounded to the nearest one-hundredth cent, shall be the U.S. average NASS nonfat dry milk survey price reported by the Department for the month, less ~~16.78~~ **21.00** cents ~~and multiplying the result~~ **with the result multiplied** by 0.99.

(n) *Protein price*. The protein price per pound, rounded to the nearest one-hundredth cent, shall be computed as follows:

\* \* \* \* \*

(1) ...

(2) Subtract ~~20.03~~ **24.00** cents from the price computed pursuant to paragraph (n)(1) of this section and multiply the result by 1.383;

(3) Add to the amount computed pursuant to paragraph (n)(2) of this section an amount computed as follows:

(i) Subtract ~~20.03~~ **24.00** cents from the price computed pursuant to paragraph (n)(1) of this section and

multiply the result by 1.572; and

\* \* \* \* \*

(o) *Other solids price.* The other solids price per pound, rounded to the nearest one-hundredth cent, shall be the U.S. average NASS dry whey survey price reported by the Department for the month minus ~~19.91~~ **23.00** cents, with the result multiplied by 1.03.

\* \* \* \* \*

(q)(3) An advanced butterfat price per pound rounded to the nearest one-hundredth cent, shall be calculated by computing a weighted average of the 2 most recent U.S. average NASS AA Butter survey prices announced before the 24th day of the month, subtracting ~~17.15~~ **21.00** cents from this average, and multiplying the result by 1.211.

**The make allowances in the component price formulas and current costs of manufacturing the products in those formulas**

NMPF proposes increases to the manufacturing cost (make) allowances in the butterfat, nonfat solids, protein, and other solids component formulas as follows:

Butterfat:	From \$0.1715 to \$0.2100 per pound of butter,
Nonfat Solids:	From \$0.1678 to \$0.2100 per pound of nonfat dry milk,
Protein:	From \$0.2003 to \$0.2400 per pound of cheddar cheese,
Other Solids:	From \$0.1991 to \$0.2300 per pound of dry whey.

These requested changes are equivalent to an increase of \$0.0385 per pound in the butter make allowance, an increase of \$0.0422 per pound in the nonfat dry milk (NFDM) make allowance, an increase of \$0.0397 per pound in the cheddar cheese make allowance, and an increase of \$0.0309 per pound in the dry whey make allowance. NMPF does not contend that these increases fully correct for the increases in butter, NFDM, cheddar cheese and dry whey manufacturing costs experienced by manufacturers since 2008, when the current make allowances were implemented. Instead, these make allowance increases represent a fair balance between the producer impact of higher make allowances and the processor impact of make allowances more closely reflecting the current cost of manufacturing commodity style butter, nonfat dry milk, cheddar cheese and dry whey. Raising make allowances to levels above those proposed will reduce producer prices to levels that would narrow margins and negatively impact the availability of adequate supplies of milk, and thereby create disorderly marketing. At the

same time, the proposed increases in make allowances will likely not ensure that all manufacturing plants will operate profitably since plants vary by location, size, age, depreciation, yield, and other factors. Indeed, the Department recognizes make allowances “will not provide enough of an allowance to assure that every processor, no matter how inefficient or high-cost, will earn a profit.”<sup>2</sup> This is because assuring all manufacturers a profit would effectively eliminate the “incentive to make a sufficient quantity of milk available for fluid use, a basic goal of the Federal milk order program.”<sup>3</sup>

### **Disorder caused by the current inadequate make allowances<sup>4</sup>**

Under Federal Order Reform, Product Price Formulas (PPF) replaced the previous direct survey of prices paid for manufacturing milk. PPFs moved the process of establishing the basis for Federal Order pricing up the marketing chain one step to survey unregulated buying and selling of wholesale, spot, commodity style, dairy products. Those dairy product prices became the foundation, working backward via economic formulas, to determine the minimum price of milk used to make those commodity dairy products. Adjusting their prices by subtracting the non-milk costs of manufacturing these products and applying appropriate yield factors determines an implied value for the components of milk used to produce them. Having accurate and updated plant processing costs, or “make allowances,” and appropriate product yield factors are critical for this indirect method of determining milk prices, which is a principal function of the Federal Order Program<sup>5</sup>. Yet a regular and systematic method of ensuring that these critical PPFs remain accurate and current has not been established.

The current make allowances, which are fixed numerically in the Federal Order regulations, were established by USDA in 2008, based on surveys of manufacturing costs in 2006 and 2007, conducted by Cornell University and by the California Department of Food and Agriculture (CDFA). Costs of manufacturing butter, nonfat dry milk, cheddar cheese and dry whey have increased since the time the data was collected. A number of NMPF members that operate manufacturing plants have indicated that their costs have risen substantially since 2008. It seems likely that the current costs of manufacturing are above the current make allowance values. The most recent survey-based study of dairy

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<sup>2</sup> 65 Fed. Reg. 76,840 (Dec. 7, 2000).

<sup>3</sup> *Id.* at 76,841.

<sup>4</sup> Direct responses to the specific questions enumerated in the “Supplemental Rules of Practice Governing Proceedings to Amend Federal Milk Marketing Agreements and Marketing Orders” are at the conclusion of each proposal. 7 C.F.R. § 900.22.

<sup>5</sup> See 64 Fed. Reg. 16,091 (evaluating alternatives to BFP based on “(a) stability and predictability; (b) simplicity, uniformity, and transparency; (c) sound economics—e.g., consistency with market conditions; and (d) reduced regulation.”).

product processing costs<sup>6</sup> was based on “modal observations” for calendar year 2018 and determined the following weighted-average processing costs, compared with the current make allowances:

<u>Product</u>	<u>Current Make Allowance (\$/lb)</u>	<u>Weighted-Average Cost (\$/lb)</u>	<u>Increase (\$/lb)</u>
Butter	\$0.1715	\$0.1411	-\$0.0304
Nonfat Dry Milk	\$0.1678	\$0.2933	\$0.1255
Cheddar Cheese	\$0.2003	\$0.2476	\$0.0473
Dry Whey	\$0.1991	\$0.2650	\$0.0659

Subsequent analyses by NMPF and other interested parties have estimated that unit costs of inputs have subsequently risen even further above these 2018 levels.

From discussions with members, a review of input price data and the output from the University of Wisconsin cost of manufacturing survey, it is clear that dairy product processing costs have increased, and therefore, average manufacturing costs for butter, nonfat dry milk, cheddar cheese, and dry whey are considerably higher than the current Federal Order make allowances. But several challenges are encountered when using existing survey plant cost data or analyses to establish updated make allowances with the specificity needed. These include:

1. The butter and nonfat dry milk manufacturing costs in the most recent University of Wisconsin (U-W) study were determined using a different cost allocation basis that was not used in the previous versions of the cost studies. The newly introduced method for cost allocation establishes the nonfat dry milk make allowance at more than twice that of the butter make allowance. Furthermore, the most recent cost study results would actually suggest a decrease to the current butter make allowance. This contradicts the study’s observation that, “Butter processing costs have only slightly increased over the last decade since the previous cost study was done. The weighted average costs are about 3¢ per pound higher and can mostly be attributed to higher processing labor costs.”<sup>7</sup> The author, upon being questioned about this result, cited several reasons for it, the most salient of which being a change in methodology for allocating costs to individual products in joint manufacturing operations. Regardless of the merits of this change in methods, updating the current make allowances to reflect this significantly different approach to cost data analysis would be extremely disruptive to butter processing operations and to dairy farmers pooling on Federal

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<sup>6</sup> Cost of Processing in Cheese, Whey, Butter and Nonfat Dry Milk Plants, Mark Stephenson, Ph.D., University of Wisconsin, Madison, December, 2021.

<sup>7</sup> *Id.* at 10.

Orders, with disorderly marketing conditions being generated by both.

2. NMPF recognizes the cost of manufacturing dairy products has increased since the make allowances were last updated. Therefore, there is clearly a need to establish a more regular and systematic method for updating the make allowances as well as the yield factors in Federal Order component price formulas. This will require providing the Department with the authority to conduct periodic manufacturing cost surveys that can supply this necessary information. NMPF is engaged with the Congress to accomplish this. Under such authority, manufacturers of the commodity dairy products referenced in these formulas would be mandated to provide auditable cost and product yield data. Manufacturers are already mandated to provide sales price data for such products pursuant to the Dairy Product Mandatory Reporting Program. As stated by Dr. Stephenson, author of the U-W cost study, “The cost structure (of) processing has clearly changed over the last ten years. ... The range of processing costs across all products is noticeably greater today than it was in 2006.” Therefore, larger, more representative sample sizes than those achievable by all the previous, voluntary studies are needed to establish proper values for the critically important make allowances and yield factors. NMPF will be seeking the enactment of such authority in the upcoming Farm Bill.
3. There are consequences to setting make allowances too low relative to the actual cost of manufacturing under a system of PPFs. Inadequate make allowances challenge manufacturing operations’ abilities to pay minimum announced milk prices and still operate their facilities at reasonable rates of return. This discourages the plant investment needed to provide market demand on a daily, seasonal and annual basis. As the Department itself noted in its Final Decision on Federal Order Reform in 1999: “The importance of using minimum prices that are market-clearing for milk used to make cheese and butter/nonfat dry milk cannot be overstated. The prices for milk used in these products must reflect supply and demand and must not exceed a level that would require handlers to pay more for milk than needed to clear the market and make a profit.”<sup>8</sup> And in its Final Decision, Proposed Rules for the current make allowances, the Department also pointed out when manufacturing costs of commodity products exceed the established make allowances, the calculated classified prices will essentially overvalue raw milk as an input. Simply put, when manufacturing costs exceed make allowances, the effect is to overvalue the milk used to make those products. The Department also noted the importance of accurate and up-to-date make allowances in determining minimum classified values of milk: “Accordingly, the

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<sup>8</sup> 64 Fed. Reg. 16,094-95 (April 2, 1999).



accuracy of deriving the minimum value of raw milk is dependent on the accuracy of the commodity sale prices reported and, in large part, the accuracy of the manufacturing cost factors, or make allowance factors, that are used in the pricing formulas.”<sup>9</sup> In short, the current, outdated make allowances need to be revised to account for increases in manufacturing costs of the four main dairy product commodities, butter, nonfat dry milk, cheddar cheese and dry whey. USDA must consider the best plant processing cost data available when updating make allowances. However, given the length of time during which the current make allowances have remained unchanged, making the sudden change to levels that reflect likely current costs would itself be disruptive to dairy producers and impose undue financial hardships on them, with potentially negative impacts on providing adequate supplies of milk to some manufacturing operations.

### **Negative impacts from outdated make allowances are unfairly borne by cooperative dairy farmers**

Cooperatives operate dairy manufacturing plants in nearly all Federal Order marketing areas. These manufacturing plants balance milk supplies in the market when Class I, II and III customers need more or less milk to service their accounts. In this way, cooperative manufacturing plants balance the market by providing an outlet for milk not needed by their customers on a monthly, weekly, and even daily basis. Cooperative manufacturing plants represent financial investments by their members. Cooperative members have paid to build and maintain their cooperatives’ manufacturing plants and are responsible for the costs to operate them. When Federal Order make allowances are established at levels below the costs of producing commodity dairy products, farmers whose cooperatives own and operate balancing plants end up absorbing costs that other market participants do not experience but benefit from the orderly marketing system enabled by the cooperatives operating milk balancing plants. As cooperatives pass the marketwide service-like balancing losses to their members via reduced pay prices, producers shipping to handlers who do not operate cooperative balancing plants do not experience these lower pay prices. This unfairly penalizes dairy cooperative members who invest in plant and marketing systems to support orderly marketing.

The dairy products referenced in the Class III and Class IV milk pricing formulas are primarily commodity products, not retail or branded products. Many of NMPF’s member cooperatives own and operate plants that manufacture commodity dairy products. To maximize plant throughput, plant managers typically set processing schedules to include a high percentage of commodity products even though these products typically have a smaller margin than branded products. This approach of

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<sup>9</sup> 78 Fed. Reg. 9269 (February 7, 2013)

maximizing a plant's processing capacity is especially important in clearing the milk supply available to local markets, as discussed previously.

### **The Proposed Solution: NMPF's specific make allowance request**

Although the current Federal Order make allowances are overdue for updates, the data available to do so are not sufficiently comprehensive and unambiguous to establish revised make allowances confidently. Accuracy and specificity are required to make such changes because "the make allowances...should cover the costs of *most* of the processing plants that receive milk pooled under the orders."<sup>10</sup> Also, because make allowances have not been altered for so many years, bringing them up to date in a single step would create disorderly market conditions due to the impact on regulated milk prices. Accordingly, NMPF recommends that the make allowances be updated as follows:

1. Provide an interim increase to alleviate the acute problems and disorderly market conditions created by the current, clearly insufficient make allowances.
2. Enact the authority for the Department to conduct mandatory, auditable plant processing cost studies, conduct such a study under that authority, and present the resulting data to the industry, which will enable interested parties to make requests for further make allowance adjustments on the basis of proper and adequate data.
3. Continue to conduct and report plant processing cost studies regularly and systematically under the same legislative authority and mandate.

NMPF's proposal strikes a balance between several objectives. It is directionally correct, increasing make allowances from their current inadequate levels but, in the absence of definitive data, not increasing them so high as to be dependent on projections or on plant processing cost surveys that have been disputed. After much debate and after an exhaustive analysis using many different methodologies including using indexing, polling NMPF members to ascertain their plants' costs, etc., NMPF adopted the recommended make allowance increases that we believe are adequate, acceptable, and reasonable. Relative to being adequate, again, NMPF proposes a two-step approach which we believe are both necessary and sufficient increases for the near-term, but more importantly, once USDA has been given the authority to conduct a mandatory cost study, then at that time the industry will have more definitive data to make necessary longer-term make allowance modifications. In terms of being acceptable and reasonable, NMPF believes a balance must be struck between the various industry stakeholders, and its recommended make allowance increases do so in an orderly, acceptable, and reasonable manner for the entire dairy industry.

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<sup>10</sup> 65 Fed. Reg. 76,839 (Dec. 7, 2000) (emphasis added).

**Responses to 7 C.F.R. § 900.22 topics**

Following are NMPF's responses to the 7 C.F.R. § 900.22 questions to be answered by proponents in a Federal Milk Marketing Order hearing request:

§900.22(a). *Explain the proposal. What is the disorderly marketing condition that the proposal is intended to address?*

The proposal would increase the current make allowances in the four basic Federal Order component price formulas as follows:

Butterfat:	From \$0.1715 to \$0.2100 per pound of butter,
Nonfat Solids:	From \$0.1678 to \$0.2100 per pound of nonfat dry milk,
Protein:	From \$0.2003 to \$0.2400 per pound of cheddar cheese,
Other Solids:	From \$0.1991 to \$0.2300 per pound of dry whey.

These increases would be sufficient to reduce the disorderly marketing conditions stemming from the current and inadequate make allowances, which have not been increased since 2008. The proposed increases are not so large as to create disorderly marketing by having too large an impact on producer milk prices. When USDA has the legislative authority to conduct mandatory, auditable plant processing cost studies and can produce results under that authority, interested parties could propose further changes to them through a subsequent hearing request.

§900.22(b). *What is the purpose of the proposal?*

The purpose of the proposal is to establish a defensible level of make allowances to correct the current disruption to the industry caused by the current, inadequate component pricing make allowances. The subsequent conduct and reporting of cost studies by USDA under legislatively-established authority that requires responses to such studies be mandatory and auditable will allow further make allowance adjustments to be considered on the basis of proper and adequate data.

§900.22(c). *Describe the current Federal order requirements or industry practices relative to the proposal.*

The current Federal Order product price formula make allowances, cited above in §900.22(a), are outdated and are not representative of the cost to produce the four basic commodity dairy products. With end-product pricing formulas, accurate make allowances are needed to determine appropriate values for milk pooled in Federal Orders in the interests of both dairy farmers and processors of dairy products.

§900.22(d). *Describe the expected impact on the industry, including on producers and handlers, and on consumers.*

The proposed increases in the component formula make allowances would lead to lower blend prices for producers. Product manufacturers would pay for producer milk at lower class prices that will be more closely aligned with their current actual value in product manufacturing. Simply computing from the price formulas, the initial effect of the proposal, based on the average of monthly dairy product prices during 2019-2022, would be to reduce the price of the Federal Order components by \$0.047 per pound for butterfat, \$0.042 per pound for nonfat solids, \$0.079 per pound for protein, and \$0.032 per pound for other solids. This then translates to a reduction in the Class III price by \$0.58 per hundredweight, the Class IV price by \$0.53 per hundredweight, and the Class I price by \$0.50 per hundredweight, which NMPF estimates would reduce the U.S. average all-milk price received by the nation's dairy farmers by \$0.54 per hundredweight. Going forward, competitive market forces of supply and demand will affect dairy product prices to mitigate this initial impact on producers and manufacturers by reducing milk production and thereby returning milk prices received by dairy farmers to levels close to what they would receive in the absence of the proposed change.

Processors will pay for producer milk at class prices that are in better relationship with their current manufacturing costs. Higher make allowances will enhance their ability to invest in their manufacturing businesses to keep them more competitive in domestic and global dairy markets.

Recent commentary on updating component price formulas postulated the following effects:

The first effect of increasing make allowances to reflect higher actual costs of manufacturing would be to lower all Class prices, and ultimately the minimum blend price that is paid to the farmer. However, asking processors to pay more than they can reasonably afford carries longer-term negative consequences, including the risk of missing sales opportunities in a rising market and losing market access over time. Inadequate make allowances may lead to underinvestment in processing facilities or result in overinvestment in low-cost plants, thereby limiting market access and allowing international export competitors to meet rising global demand for high-value dairy products. However,

make allowances are not meant to guarantee profit for handlers or represent their full cost of goods sold.<sup>11</sup>

§900.22(e). *What are the expected effects on small businesses as defined by the Regulatory Flexibility Act (5 U.S.C. §601-612)?*

Most businesses in the dairy industry meet the definition of a small business. Table 1 provides simple estimates of the average herd size and average milk sales per herd of the producers pooled on the individual Federal Orders in 2022. These estimates are weighted averages by herd sizes in the individual states. They would indicate that approximately 90% of producers pooled in Federal Orders in 2022 would meet the current Small Business Administration small business standard of \$3.75 million or less in annual sales.

**Table 1. Estimated Dairy Herd Statistics in Federal Milk Marketing Order Areas, 2022**

<b>Order #</b>	<b>Licensed Dairy Herds</b>	<b>Average Herd Size</b>	<b>Average Sales per Herd</b>
		<i>Head</i>	<i>Mil.\$/Yr</i>
1	3,668	171	\$1.0
5	769	231	\$1.3
6	56	1,617	\$9.1
7	620	394	\$2.0
30	8,338	352	\$1.4
32	2,125	772	\$3.2
33	4,107	211	\$1.4
51	1,115	1,544	\$8.7
124	508	777	\$4.6
126	435	2,085	\$12.5
131	80	2,463	\$14.4

Estimates by National Milk Producers Federation

<sup>11</sup> Tanner Ehmke, “Updating Make Allowances is Central to the Future of Federal Milk Marketing Orders” (Jan. 19, 2023), <https://www.cobank.com/knowledge-exchange/dairy/updating-make-allowances-is-central-to-the-future-of-federal-milk-marketing-orders>.

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Regulation of milk prices, and the resulting revenues and costs, are size-independent for producers and processors alike under Federal Orders. Most of the adjustments and impacts described under §900.22(d) above will apply in this context.

The Proponent's analysis is that the proposed increases in make allowances will have a modest initial impact on small businesses. The initial impact would be a modest reduction in Class prices, but competitive market forces will act to bring milk prices to dairy farmers as mostly small businesses back close to the levels they would have had in the absence of any regulatory changes. Small business dairy product manufacturers will have their costs of manufacturing their products more fully accounted for in their payments for milk into Federal Order pools.

§900.22(f). *How would adoption of the proposal increase or decrease costs to producers, handlers, others in the marketing chain, consumers, the Market Administrator offices and/or the Secretary?*

The proposed increases in make allowances will not affect the cost of producing milk by dairy farmers although it will impact their profitability as the milk price is decreased. They will have the effect of reducing the cost of procuring milk for dairy product manufacturers, some of which might be passed on to consumers. It will not affect costs for the Market Administrator offices or the Secretary.

§900.22(g). *Would a pre-hearing information session be helpful to explain the proposal?*

Given the comprehensive list of proposed changes, a pre-hearing information session may be helpful to explain this proposal. Accordingly, NMPF, as a petitioner, would support holding a pre-hearing information session.

**Proposal 2: Remove the U.S. average survey price for 500-pound barrel cheddar cheese from the computation of the protein price**

NMPF also requests an amendment to the cheese reference prices specified in the protein component of the Class III pricing formula as part of the request to the Secretary to call a hearing pursuant to 7 C.F.R. § 900.1, *et seq.*, to, *inter alia*.

**Amend 7 C.F.R. § 1000.50(n), applicable to all federal milk marketing orders, to provide:**

**§ 1000.50 Class prices, component prices, and advanced pricing factors.**

\* \* \* \* \*

(n) ***Protein price.*** Strike all subsequent parts of this paragraph and insert in lieu thereof:

**(1) Subtract 20.03 cents from the from the U.S. average survey price for 40-lb. block cheese reported by the Department for the month and multiply the result by 1.383;**

**(2) Add to the amount computed pursuant to paragraph (n)(1) of this section an amount computed as follows:**

- (i) Subtract 20.03 cents from the U.S. average survey price for 40-lb. block cheese reported by the Department for the month and multiply the result by 1.572; and**
- (ii) Subtract 0.9 times the butterfat price computed pursuant to paragraph (l) of this section from the amount computed pursuant to paragraph (n)(2)(i) of this section; and**
- (iii) Multiply the amount computed pursuant to paragraph (n)(2)(ii) of this section by 1.17.**

**Disorder caused by the inclusion of 500-pound barrel cheddar cheese prices in the current computation of the protein price**

The Class III milk price in Federal Orders is derived from calculations of component prices for protein, butterfat, and other solids. The protein component price formula references two survey price series for cheddar cheese submitted by manufacturers through the Dairy Product Mandatory Reporting Program (DPMRP) and reported in the weekly National Dairy Products Sales Report (NDPSR). These are the 40-pound yellow cheddar cheese (block) price and the 500-pound barrel cheddar cheese (barrel) price. The total cheese price used in the protein price calculation is the weighted average of the block and the moisture-adjusted barrel price, plus \$0.03 per pound, weighted by sales volumes reported in the survey. The respective reported sales volumes of block and barrel cheese are roughly equal, with blocks ranging from 44% and 55% of total reported volume since 2017.

The Federal Order Reform Final Decision explained the current cheese price computation:

The NASS cheese survey price will be determined by adding three cents to the moisture-adjusted barrel price and then computing a [volume-]weighted average price using the block cheese price and the adjusted barrel price ... Including both block and barrel cheese in the price computation increases the sample size by about 150 percent, giving a better representation of the cheese market. Since the make allowance [in the protein component price formula] is for block cheese, the barrel cheese price must be adjusted to account for the difference in cost for making block versus barrel cheese. The three cents that is added to the barrel cheese price is generally considered to be the industry standard cost difference between processing barrel cheese and processing block cheese.<sup>12</sup>

This method of computing the cheese price for the protein component formula worked reasonably well as long as the difference in the respective market prices of blocks and barrels remained close to the assumed \$0.03 per pound processing cost difference. From 2000 to 2016, the spread between the Chicago Mercantile Exchange block and barrel cheese spot prices annually averaged \$0.03 per pound with a tight range of \$0.02 per pound to \$0.05 per pound. However, the correlation between the block and barrel prices declined significantly from 2017 through 2022. The average spread of block over barrel prices during this period was \$0.12 per pound with a much wider range of \$0.02 per pound to \$0.28 per pound. The highest monthly block-barrel price spread during this period was \$0.69 per pound and the lowest was -\$0.29 per pound (meaning that barrel prices were higher than block prices). This change in price relationship is shown clearly in Figures 1 and 2.

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<sup>12</sup> 64 Fed. Reg. 16,098 (emphasis added).



Figure 1. Block-Barrel Spread History

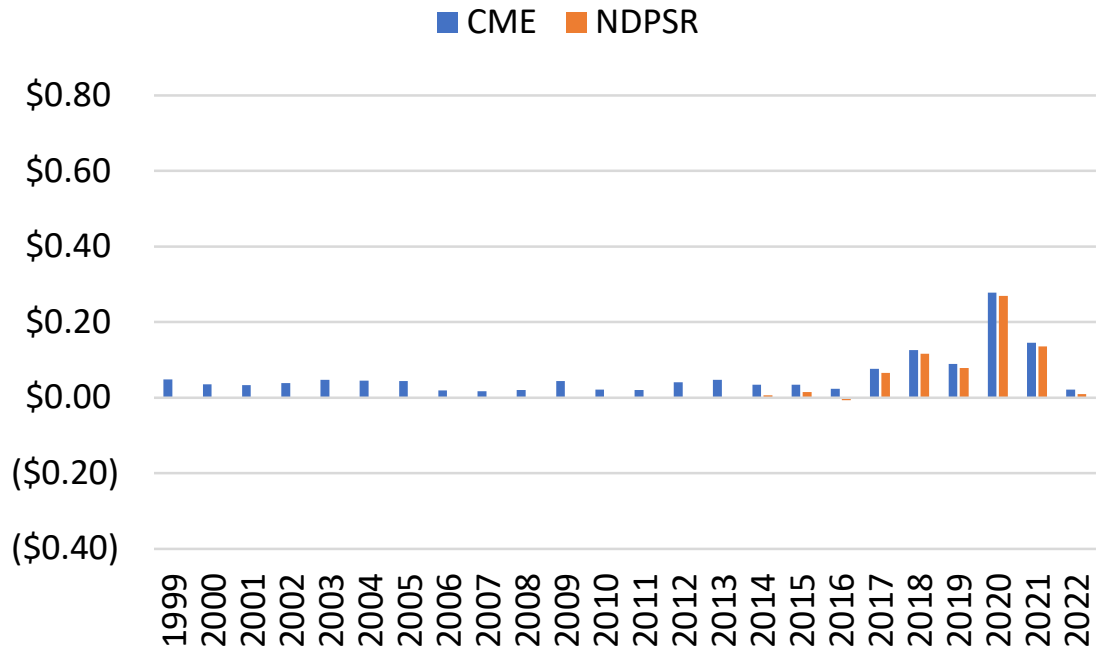
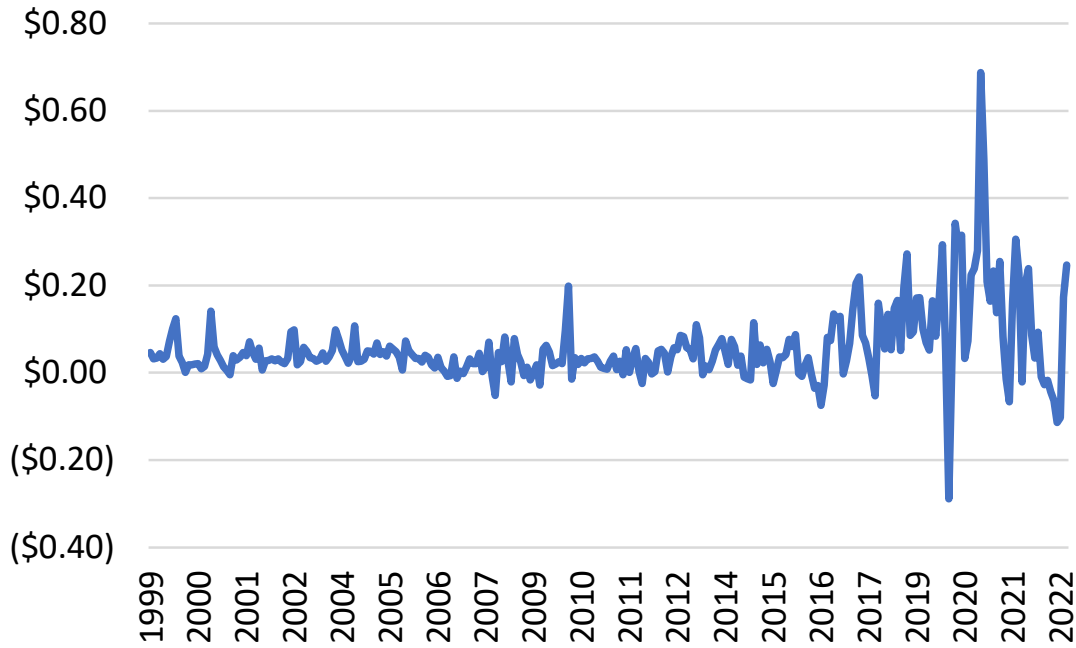


Figure 2. CME Monthly Block-Barrel Spread



The CME block cheddar price is used as a pricing index for most cheese produced in the United States. Cheddar 40-pound blocks, 640-pound blocks, mozzarella, other American-type cheese, and other types of cheese, including cream cheese and Hispanic cheeses, typically use the 40-pound block price as an index for pricing purposes. Approximately 90% of natural cheese produced in the United States is sold using the CME 40-block price as a pricing index. Barrel cheese represents only an estimated 7% of U.S.-manufactured natural cheese. The CME barrel cheese price is used as an index to price barrel cheese and processed cheese products but not often used to price other natural cheeses. It is estimated that the CME barrel cheese price is used to price only about 10% of total U.S.-produced natural cheeses.

Total U.S. cheese production in 2022 was 13.9 billion pounds, with 28%, or 3.9 billion pounds, represented by cheddar cheese. Total barrel cheese production capacity in the United States is estimated to be 1 billion pounds annually. Breaking out barrel production from all cheddar cheese production leaves 2.9 billion pounds of block cheddar, in the form of 40-pound and 640-pound blocks.

The volatile block/barrel spread over the past five years negatively impacted both dairy producers and processors. Historically, using both block and barrel prices in the Class III pricing formula effectively increased the volume of cheddar cheese reported in the NDPSR. Because the block-barrel price spread was relatively consistent at \$0.03 per pound, including both block and barrel prices did not result in unpredictable and disruptive fluctuations in the Class III price. Since 2017, however, the significantly wider and increasingly volatile block-barrel price spread has caused instability in the cheese market. It has reduced revenue for dairy producers because barrels, at approximately half of the price survey volume, over-represent the estimated 10% of total U.S. cheese production that relies on the CME barrel market as a price index.

**The Proposed Solution: remove the survey price for 500-pound barrel cheddar cheese from the computation of the protein price**

It is clear that the intent of using barrel cheese prices to determine protein price was a measure to bolster the volume of the survey to determine the requisite cheese price. It did so by adjusting the barrel cheese price to “look” like a block cheese price. What worked well for a decade or so became a disorderly marketing condition when the demand for barrel cheese declined and the spread between the block and barrel prices widened. This widening of the prices no longer results in barrel prices “looking” like block prices. The increase in the spread has lowered Class III and producer prices and created the disorderly marketing condition.

Eliminating the cheddar cheese barrel price series from the Class III price calculation will reduce financial uncertainty for processors and will drive both block and barrel processors to use the 40-pound block market as a price index. Price risk management opportunities for processors will be enhanced because there are risk management tools built around block cheese that do not exist for barrels. Existing risk management tools, including the Class III price and the cheese futures and options, will become more effective means to price cheese for customers and to manage input cost risk. It will also result in Federal Order pool values more accurately reflecting the processor’s value of the milk used to produce cheese. Eliminating the 500-pound barrel cheddar price from consideration will also allow block cheese futures and options to become more effective tools to manage price risk.

**Responses to 7 C.F.R. § 900.22 topics**

The following are NMPF's responses to the 7 C.F.R. § 900.22 questions to be answered by proponents in a Federal Milk Marketing Order hearing request:

§900.22(a). *Explain the proposal. What is the disorderly marketing condition that the proposal is intended to address?*

The current Federal Order protein component price formula has understated the value of protein in producer milk for the past five years, and will likely continue to do so, by including a disproportionate volume of cheddar cheese in 500-pound barrel form in the cheese price calculation. The price relationship between 40-pound blocks and 500-pound barrels has become unstable over the past six years and will likely continue to remain so.

§900.22(b). *What is the purpose of the proposal?*

The purpose of the proposal is to provide a more accurate value for milk used to produce cheese than that provided by the current protein component price formula.

§900.22(c). *Describe the current Federal order requirements or industry practices relative to the proposal.*

The cheese survey price used to compute the protein component price is currently determined by adding \$0.03 per pound to the moisture-adjusted barrel cheese price and then computing a [volume-]weighted average price using the block cheese price and the moisture-adjusted barrel price. As constructed, the Class III price formula places too much value on the market information imparted by the barrel cheese price. Currently, barrel cheese represents a little over 50% of the cheddar cheese sales volumes reported in the price survey. However, only about 10% of the cheese produced in the U.S. is priced using the CME barrel cheese price as an index.

§900.22(d). *Describe the expected impact on the industry, including on producers and handlers, and on consumers.*

The proposed elimination of barrel cheddar cheese prices from the Class III pricing formula would tend to lead to higher Class III prices, which would lead to higher blend prices for producers. Cheese manufacturers would pay for producer milk at generally higher class prices that will be more closely aligned with their current actual value in manufacturing cheese. Computing from the price formulas, the initial effect of the proposal, based on the average of monthly dairy product prices during 2019-2022, would be to increase the price of cheese used in the protein formula by \$0.047 per pound, the protein price by \$0.15 per pound, the Class III price by \$0.45 per hundredweight, and

the Class I price by \$0.20 per hundredweight, which NMPF estimates would increase the U.S. average all-milk price received by the nation's dairy farmers by \$0.25 per hundredweight. Going forward, competitive market forces of supply and demand will impact dairy product prices and premiums to mitigate any initial impact on producers and manufacturers. The forces of supply and demand will return milk prices received by dairy farmers to levels close to what they would receive in the absence of the proposed change.

*§900.22(e). What are the expected effects on small businesses as defined by the Regulatory Flexibility Act (5 U.S.C. §601-612)?*

Most businesses in the dairy industry meet the definition of a small business. Regulation of milk prices, and the resulting revenues and costs, are size-independent for producers and processors alike under Federal Orders. Most of the adjustments and impacts described under §900.22(d) above will apply in this context.

NMPF's analysis is that the impact of this proposal, and the potential increases in Class III prices which could result, will not have an initial significant impact on small businesses, either producers or handlers, in the context of the entire package of Federal Order regulatory changes proposed by NMPF. The initial impact of this Proposal would be a modest increase in Class III prices, while other changes in the package, such as the increased make allowances, would decrease Class III prices to handlers. For producers there are both pluses and minuses in the full package of proposals. but competitive market forces would act to bring milk prices back close to the levels they would have had in the absence of any regulatory changes.

*§900.22(f). How would adoption of the proposal increase or decrease costs to producers, handlers, others in the marketing chain, consumers, the Market Administrator offices and/or the Secretary?*

In their capacity as producers of milk, the proposed elimination of the barrel price for cheddar cheese in the Class III formula should have no impact on the costs of producing milk. As previously discussed, the impact on costs to processors and consumers is not quantifiable due to the, at best, imprecise relationships between regulated milk prices and the final full cost of raw milk, and the regulated cost of milk and consumer retail prices.

*§900.22(g). Would a pre-hearing information session be helpful to explain the proposal?*

Given the comprehensive list of proposed changes, a pre-hearing information session may be helpful to explain this proposal. Accordingly, NMPF, as a petitioner, would support holding a pre-hearing information session.

**Proposal 3: Restore the original Federal Order Reform Class I skim milk price mover**

NMPF also requests that the Secretary call a hearing pursuant to 7 C.F.R. § 900.1, *et seq.*, to, *inter alia*, amend the Class I skim milk price, which is the mover for Class I skim milk prices in all Federal Orders, as follows:

**Amend 7 C.F.R. § 1000.50(b) applicable to all federal milk marketing orders to provide:**

**§ 1000.50 Class prices, component prices, and advanced pricing factors.**

\* \* \* \* \*

(b) *Class I skim milk price.* The Class I skim milk price per hundredweight shall be the adjusted Class I differential specified in § 1000.52, plus the adjustment to Class I prices specified in §§ 1005.51(b), 1006.51(b) and 1007.51(b) of this chapter, plus the ~~simple average~~ **higher** of the advanced pricing factors computed in paragraph (q)(1) and (2) of this section rounded to the nearest cent, ~~plus \$0.74 per hundredweight.~~

**Evolution of the current Class I mover**

The current language in 7 C.F.R. § 1000.50(b) is the product of two rulemaking decisions: (1) Federal Order Reform<sup>13</sup>, and (2) the Final Rule implementing Section 1403 of the Agriculture Improvement Act of 2018<sup>14</sup>. Understanding both of those actions is important to understanding the deficiencies of the Class I mover during periods of market instability since its implementation in May, 2019.

In Federal Order Reform, USDA adopted a new Class I mover for the newly consolidated eleven federal orders to replace the BFP, which was the mover for Class I prices prior to reform. The BFP was derived from a survey of prices paid for Grade B milk by dairy manufacturing plants, processing primarily butter, nonfat dry milk, and cheese. It was, therefore, reported as a single price which blended the value of Grade B milk used to manufacture butter, nonfat dry milk powder, and cheese products. The BFP was discontinued at the end of 1999 due to the declining and increasingly unrepresentative volume of Grade B milk, and the Federal Order system subsequently

<sup>13</sup> 64 Fed. Reg. 16,026 (April 2, 1999).

<sup>14</sup> 84 Fed. Reg. 8,590 (Mar. 11, 2019).

adopted end product price formulas to determine minimum class prices. The transition to these new class price formulas involved the uniform adoption of four classes of milk, including two full manufacturing use classes, III and IV. When a new Class I mover had to be identified, the question arose as to which manufacturing class price to use as its basis. The Department determined the mover should be the “higher of” the most currently calculated advanced Class III or Class IV skim milk price.

Federal Order Reform identifies at least four reasons for using the higher of Class III or Class IV as the mover and base value for Class I skim milk prices. First, basing Class I on the higher of III or IV would “more accurately reflect the value of (milk in) these different categories of use” in a four class system. Furthermore, given the separation of manufacturing milk into two classes, using the higher of Class III and IV would “assure that shifts in demand for any one manufactured product will not lower . . . Class I prices.”<sup>15</sup> Second, using the higher of the two classes “to move Class I prices [will help] to reduce the volatility in milk prices.”<sup>16</sup> Third, a major consideration was to address class price inversions and depooling. The decision stated:

Class price inversion occurs when a market’s regulated price for milk used in manufacturing exceeds the Class I (fluid) milk price in a given month and causes serious competitive inequities among dairy farmers and regulated handlers. ... Thus, an inequitable situation has developed where milk for manufacturing is pooled only when associating it with a marketwide pool increases returns. Illustrative of the worsening class price inversion problem are the growing volumes of milk that, while normally associated with Federal milk orders, are not being pooled due to price inversion problems. ... Since volatility in the manufactured product markets is expected to continue, the Class I price mover developed as part of this Federal milk order reform process should address this disorderly marketing situation.<sup>17</sup>

Finally, and perhaps most significantly, the purpose was to assist Class I handlers in competing for a milk supply. “In some markets the use of a simple or even weighted average of the various manufacturing values may inhibit the ability of Class I handlers to procure milk supplies in competition with those plants that make the higher-valued of the manufactured products. Use of the higher of the Class III or Class IV price will make it

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<sup>15</sup> 64 Fed. Reg. at 16,094.

<sup>16</sup> *Id.*

<sup>17</sup> *Id.* at 16,102-03.

more difficult to draw milk away from Class I uses for manufacturing.”<sup>18</sup> Indeed, the Department recognized “[t]he provisions adopted in the [Federal Order Reform] best fulfill the requirements of the AMAA.”<sup>19</sup> Accordingly, the Department concluded that the higher of the most current Class III or Class IV value should be the mover for Class I prices. This pricing for the Class I mover prevailed in all orders in the Federal Order system until the 2018 legislation.

Section 1403 of the Agriculture Improvement Act of 2018, which was implemented in the 2019 Final Rule, changed the Class I mover to the current language, which uses the average of the Class III and Class IV prices plus a fixed differential of \$.74 per hundredweight.<sup>20</sup> This legislated change in the mover was requested by Class I handler interests in order to allow them the ability to hedge the cost of Class I milk in the dairy product futures markets. NMPF acquiesced in this request, subject to the incorporation of the \$.74 per hundredweight fixed differential. That differential represented the average value that the higher of Class III and IV contributed to the Class I mover, relative to the average of Class III and IV, from January 2000 through August 2017. Thus, the intention of both Class I milk buyers and dairy farmer sellers was that the change would be revenue neutral and would accommodate the buyers’ desires to better manage their price risk without harming the sellers.<sup>21</sup> The Department reflected this understanding of the amendatory language when promulgating the Final Rule.

The change in the Class 1 price formula applies uniformly to both large and small businesses. The dairy industry has calculated that applying the “higher of” provisions to skim milk prices has returned a price \$0.74 per hundredweight above the average of the two factors since the pricing formulas were implemented in 2000. Thus, the inclusion of the \$0.74 in the calculation should make the change roughly revenue neutral. At the same time, it is anticipated that using the average of the Class III and Class IV advanced pricing factors in the Class I skim milk price formula will allow handlers to better manage volatility in monthly Class I skim milk prices using Class III milk and Class IV milk futures and options. Until now, uncertainty about which Class price will end up being higher each month has made effective hedging difficult. Amending

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<sup>18</sup> *Id.* at 16,103.

<sup>19</sup> *Id.* at 16,042.

<sup>20</sup> 84 Fed. Reg. 8,590

<sup>21</sup> While the objective of facilitating price risk management strategies for fluid milk processors may have merit, it is not an objective of federal orders, and most definitely not one that should come at the expense of maintaining orderly marketing.



the Class I skim milk price provisions may help small businesses better utilize currently available risk management tools.<sup>22</sup>

Notably, this statement did not refer to the four reasons for originally adopting the “higher of” mover enumerated in the 1999 Final Decision. Because the 2019 amendment has not functioned as intended or anticipated by NMPF, it has exacerbated disorderly marketing conditions, has not been revenue neutral, and will continue to have deleterious effects on the dairy industry so long as it is in place, this rulemaking is requested.

### **Disorder caused by the average of plus \$0.74 per hundredweight Class I mover**

Comparing the “higher-of” Class I formula, in operation from January 2000 to April 2019, to the average of plus \$0.74 per hundredweight Class I formula, in operation since May 2019, reveals a clear asymmetrical impact. The higher of Class I mover will exceed the “average of” Class I mover whenever the Class III and IV advanced skim milk pricing factors differ by more than \$1.48 per hundredweight. It does not matter which of the advanced skim pricing factors is higher. The reverse will be true whenever the advanced skim pricing factors differ by less than \$1.48 per hundredweight. Thus, the maximum amount by which the “average of” Class I mover can exceed the higher of Class I mover is \$0.74 per hundredweight, which occurs when the two advanced skim milk pricing factors are equal. However, there is no specific limit by which the “average of” Class I mover can fall below the higher of Class I mover.

The asymmetric price risk inherent in the current Class I mover became evident during the second half of 2020 and then again during much of 2022. During these periods, the current Class I mover fell mostly, and significantly, below the previous “higher-of” mover. Since it became effective in May 2019, the cumulative market losses in pooled Class I skim milk values in all orders has reached \$937.9 million through January 2023. NMPF greatly appreciates the Secretary’s partial compensation of these losses through the Pandemic Market Volatility Assistance Program (PMVAP). However, this would not have been needed if the amendment had performed as expected.

The change also increased the level of disorderly marketing during this period by reducing Class I prices relative to the other classes and thus creating greater incentives to depool milk. This was inconsistent with the Federal Order Reform justification that the “higher-of” mover would “assure that shifts in demand for any one manufactured product will not lower . . . Class I prices.”<sup>23</sup> The enhanced demand for cheese generated by the

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<sup>22</sup> 84 Fed. Reg. 8,591.

<sup>23</sup> *Id.*

Farmers to Families Food Box Program, relative to the demand for butter and nonfat dry milk, widened the spread between Class III and Class IV prices beyond the \$1.48/cwt break point. This substantially lowered Class I prices compared to where the previous “higher-of” would have established them, created class price inversions and generated substantial depooling of Class III milk during the second half of 2020. Class price inversions recurred in 2022, because of an unusually long period of tight milk supplies. This led to relatively high Class IV skim milk prices, because cheese and whey plants continued to receive relatively adequate milk supplies while butter and nonfat dry milk plants played their traditional balancing roles. The result was again price volatility, and substantial depooling of Class IV skim milk.

In sum, the current Class I mover does not operate as intended because it builds in an unintended asymmetric risk to producer income, which has resulted in millions of dollars in losses of producer income. The current Class I mover dramatically increases the marketing disorder represented by volatile volumes of depooled milk. Market and price volatility continue to be a basic feature of dairy markets and can be anticipated to occur in the future. The experiment with the average of Class I mover is a failure and the Federal Orders should be amended to return to the higher of formula.

### **The Proposed Solution: Return to the Higher of Class III and Class IV mover**

NMPF proposes to amend the Class I skim milk price mover to return it to its original form, as initially adopted in Federal Order Reform; namely, the higher of the Class III and Class IV Advanced Skim Milk Pricing Factors. All of the reasons the Department cited for that original decision, as previously summarized, still apply to contemporary dairy markets and will continue to do so going forward.

### **Responses to 7 C.F.R. § 900.22 topics**

Following are NMPF’s responses to the 7 C.F.R. § 900.22 questions to be answered by proponents in a Federal Milk Marketing Order hearing request:

§900.22(a). *Explain the proposal. What is the disorderly marketing condition that the proposal is intended to address?*

The incorporation of the revised Class I mover formula, specifically the Class I skim milk price in §1000.50(b) as required under the 2018 Farm Bill, magnified the unprecedented and unforeseeable volatility in the marketplace related to the COVID-19 pandemic, exacerbating seriously disorderly marketing conditions, including extraordinary depooling and extremely negative producer price differentials (PPDs). Those disruptions have continued, albeit less dramatically, since 2020 and can be

expected to continue in the future. The proposal is intended to greatly limit, to the extent achievable through regulatory changes, the negative impact of such marketing disorder.

§900.22(b). *What is the purpose of the proposal?*

The purpose of the proposal is to stabilize the relationship between class prices in the Federal Order system, thereby limiting regulated class price inversions caused by divergences in the Federal Order manufacturing class prices. It is also to ensure against the downside risk to producer prices and incomes relative to those provided by the original Class I mover recommended by the Secretary in Federal Order Reform.

§900.22(c). *Describe the current Federal order requirements or industry practices relative to the proposal.*

The current Federal Order provision was locked in place for two years by Congressional action codified in the 2018 Farm Bill. The provision, which was intended to operate in a revenue neutral manner, bore with it an asymmetric price risk, which should not have been influential if dairy product commodity prices stayed within a historic parameter space. From early 2020 until present, dairy product commodity prices have not followed historic patterns. The asymmetric price risk inherent in the current Class I mover was revealed and contributed to marketing disorder during the legislatively locked-in period.

§900.22(d). *Describe the expected impact on the industry, including on producers and handlers, and on consumers.*

The proposed amendments will correct the unintended and unanticipated defects in the current Federal Order language, thereby restoring the intended functionality of the Class I mover for the future. Re-occurrence of the price divergences and extensive depooling that occurred will be appropriately limited.

§900.22(e). *What are the expected effects on small businesses as defined by the Regulatory Flexibility Act (5 U.S.C. §601-612)?*

The majority of dairy farmers whose milk is priced by Federal Orders qualify as small businesses. These producers will benefit from the proposal, given the asymmetric risk to producers inherent in the current Class I mover. It is difficult to predict a specific amount of such benefits, but the results of the mover change since May 2019 could be considered an example. In 2019, when implementing the current Class I mover language,

AMS estimated that 98% of the producers pooled in Federal Orders in May 2017 “would be considered small businesses.”<sup>24</sup>

Any regulated handlers which would also be considered small businesses will largely not be adversely impacted. Their regulatory status would not change and regulated minimum prices will continue to apply uniformly to all market participants. Fluid milk processors who have based hedging strategies for Class I milk prices on the current Class I mover will need to revisit the strategies they employed during the nineteen years the prior Class I mover was in effect.

*§900.22(f). How would adoption of the proposal increase or decrease costs to producers, handlers, others in the marketing chain, consumers, the Market Administrator offices and/or the Secretary?*

Producers will see no cost impact. The amendments will improve producer revenue. Determination of fluid handlers’ costs of milk will revert to the formula used from January 2000 through April 2019. The result will be to restore the intended class price relationships for producers as well as for Class I handlers. Discussions with some Class I processors indicate that the industry’s use of price risk management remains small relative to total Class I sales and is mostly limited to milk used to produce shelf-stable fluid milk products. As the share of total fluid milk processed by dairy cooperatives, which mostly include NMPF members, continues to increase, NMPF certainly has incentives to assist the development of price risk management tools.

Other non-fluid handlers and others in the marketing chain are not expected to be impacted.

Retail fluid milk prices are not regulated under Federal Orders. The indirect effect of Federal Orders on milk prices received by producers and therefore on wholesale prices of fluid milk will itself have an indirect effect on retail prices of fluid milk products. However, since Federal Orders do not directly affect the cost of producing milk or how milk is marketed, the initial impact of the proposed changes are expected to dissipate after just a few years. Higher Class I prices will encourage more milk to be produced, which will then cause Class I prices to decrease. Simply, the long-run impact on consumer prices of the proposed changes will be minimal.

Market Administrators and USDA will not realize a cost impact.

*§900.22(g). Would a pre-hearing information session be helpful to explain the proposal?*

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<sup>24</sup> *Id.* at 8,591.

Given the comprehensive list of proposed changes, a pre-hearing information session may be helpful to explain this proposal. Accordingly, NMPF, as a petitioner, would support holding a pre-hearing information session.

**Proposal 4: Update the milk component factors in the skim milk price formulas**

NMPF also requests amendments to the milk component factors in the skim milk price formulas as part of the request to the Secretary to call a hearing pursuant to 7 C.F.R. § 900.1, *et seq.*, to, *inter alia*.

**Amend 7 C.F.R. § 1000.50(f), (i), (k), and (q), applicable to all federal milk marketing orders, and 7 C.F.R. § 1000.51 to provide:**

**§ 1000.50 Class prices, component prices, and advanced pricing factors.**

\* \* \* \* \*

(f) *Class II nonfat solids price.* The Class II nonfat solids price per pound, rounded to the nearest one-hundredth cent, shall be the Class II skim milk price divided by ~~9~~ **the applicable nonfat solids component factor described in § 1000.51.**

\* \* \* \* \*

(i) *Class III skim milk price.* The Class III skim milk price per hundredweight, rounded to the nearest cent, shall be the protein price per pound times ~~3.1~~ **the applicable protein component factor described in § 1000.51** plus the other solids price per pound times ~~5.9~~ **the applicable other solids component factor described in § 1000.51.**

\* \* \* \* \*

(k) *Class IV skim milk price.* The Class IV skim milk price per hundredweight, rounded to the nearest cent, shall be the nonfat solids price per pound times ~~9~~ **the applicable nonfat solids component factor described in § 1000.51.**

\* \* \* \* \*

(q) *Advanced pricing factors.* ...

(1) ...

- (i) ...
  - (ii) Multiply the protein price computed in paragraph (q)(1)(i) of this section by ~~3.1~~ **the applicable protein component factor described in § 1000.51;**
  - (iii) Multiply the other solids price per pound computed in paragraph (q)(1)(i) of this section by ~~5.9~~ **the applicable other solids component factor described in § 1000.51;** and
  - (iv) ...
- (2) ...
- (i) ...
  - (ii) Multiply the nonfat solids price computed in paragraph (q)(2)(i) of this section by ~~9~~ **the applicable nonfat solids component factor described in § 1000.51.**

\* \* \* \* \*

**§ 1000.51 ~~Reserved~~ Milk Component Factors**

- (1) Upon the implementation of this Order, the component factor for protein, other solids and nonfat solids shall be the following:**
  - (i) Protein 3.1;**
  - (ii) Other solids 5.9; and**
  - (iii) Nonfat solids 9.0.**
- (2) Beginning the first day of the 12th month after implementation of this Order, the component factors for protein, other solids and nonfat solids shall be the following:**
  - (i) Protein 3.35;**
  - (ii) Other solids 6.01; and**
  - (iii) Nonfat solids 9.36.**
- (3) By February 28th of each year beginning one year after the implementation of paragraph 2 of this section, the component factors in**

**paragraph 2 of this section will be updated to the most recent three year-weighted average component tests of producer milk in all Orders, if any one factor is at least 0.7 percentage points higher than those currently in effect.**

**(i) Implementation of the updated component factors under this section shall be announced no later than 5 days after the calculation that triggers a change and shall become effective the first day of March of the following year.**

### **The milk component factors in the skim milk price formulas**

The Federal Order skim milk price formulas were constructed to be reflective of the content of the skim portion of producer milk. Over the course of 23 years, the milk component content has increased through improved genetics, better feeds and feeding practices and better cow comfort management, among other factors.

For manufacturing prices in Federal Orders with multiple component pricing (MCP), the increase in milk component levels are reflected in Classes II, III and IV because Federal Orders with MCP price every pound of skim components. However, the recognition of these higher component tests has not occurred in determining Class I skim milk prices in all orders and Class II, III and IV prices in the three Southern orders and the Arizona order.

With Federal Order Reform, the component averages used to calculate the skim portion of the Class III and Class IV prices were set at 3.1% protein and 5.9% other solids. Adding the protein and other solids value resulted in the 9.0% nonfat solids factor used in the Class II skim calculation. These factors were based on the historic practice of using 3.5% butterfat composition for milk to quote class prices for producer milk, not the actual composition of producer skim milk.

The USDA fact sheet on “Calculating Class III Price: Details” (attached) defines the “standard cwt of milk components” as “3.5 lb butterfat and 2.99 lb protein” (Formula Detail 3). It therefore specifies “3.1 = Pounds of protein in 100 pounds of skim milk” (Formula Detail 4), since  $2.99/(1-.035) = 3.1$ . The USDA fact sheet on “Calculating Class IV Price: Details” (attached) specifies “9.0 = Factor representing pounds of nonfat solids found in a standard 100 pounds of skim milk” (Formula Detail 3). Therefore, Formula Detail 4 in the USDA fact sheet on “Calculating Class III Price: Details” specifies “5.9 = Pounds of other solids in 100 pounds of skim milk”, since  $9.0 - 3.1 = 5.9$ .

The current Class III and Class IV formulas were adopted as replacements for the prior BFP in implementing Federal Order Reform. This affected the original choice of the current Class III and Class IV skim milk composition factors in several ways. “One of the initial requirements of a basic formula price replacement, based on the assumption that

the national supply and demand for manufacturing milk as reflected in the current BFP is in relatively good balance, is that the price level not deviate greatly from the current basic formula price.”<sup>25</sup> Also, “In addition to comparing the Class III and Class IV price series to the current BFP, the Class III price was also compared to the California 4b price, while the Class IV price was compared to the Class III–A price and to the California 4a price” ... since it was deemed important that the Class III and Class IV prices not result “in prices that put plants regulated by Federal orders at a competitive disadvantage to California plants and that alignment with California pricing was essential.”<sup>26</sup>

These comparisons were made with all prices “expressed on a per hundredweight basis with 3.5 percent butterfat. The Class III price was determined by using 3.1 pounds of protein and 5.9 pounds of other solids in 100 pounds of skim milk. ... The same procedure was used for the Class IV price, with 9 pounds of nonfat solids in a hundred pounds of skim milk.”<sup>27</sup> Since those comparisons indicated a reasonably close alignment, USDA concluded that “The Class III and Class IV prices clearly reflect the value of the milk used in the respective manufactured products.”<sup>28</sup>

Other than some loose ties to historic industry practices and milk content assumptions, there is no further justification in the Federal Order Reform for the current Class III and Class IV skim milk composition factors, that we can find. In particular, there is no indication that they were based on the actual composition of producer milk at the time these factors were adopted, which the USDA National Agricultural Statistics Service reported as 3.67 percent butterfat for fluid grade milk in 1999.

### **Disorder caused by the current milk component factors in the skim milk price formulas**

Seven of the eleven Federal Orders, representing almost 90% of Federal Order milk production, use MCP. Dairy farmers have responded to MCP’s economic signals by significantly increasing protein and other solids levels in the skim portion of milk. Based on available data, over the past three years (2020-2022), the average protein and other solids content in Federal Order producer skim milk are 3.35 percent and 6.01 percent, respectively, a significant increase over the past 22 years.

Two major functions of Federal Orders are:

- 1) ensure consumers have an adequate supply of milk for fluid consumption, and
- 2) promote orderly marketing of milk

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<sup>25</sup> 64 Fed. Reg. at 16,100.

<sup>26</sup> *Id.*

<sup>27</sup> *Id.* at 16,101.

<sup>28</sup> *Id.*



In the seven Federal Orders with MCP, increased protein and other solids component levels have led to skim milk prices increasing relative to the other four Federal Orders without MCP. In all orders, the increase in component levels has decreased the price difference between the Class I skim milk price and skim milk prices for Classes II, III, and IV. This structural change in the U.S. dairy industry has made it increasingly difficult for Federal Orders to meet these major purposes, for the following reasons:

1. In MCP orders, the producers' share of the generally higher Class I pool value is provided through the PPD. As previously stated, higher component levels increase manufacturing skim values. By construct, and because of fixed formulaic factors for protein and other solids in the Class I formula, milk containing higher protein and other solids levels does not increase the Class I skim value. This in turn allows manufacturing milk prices to rise relative to the Class I price. As pooled component tests increased, but with no commensurate revenue from Class I skim values keeping pace, more dollars were paid out on all the pooled milk components, which diluted the dollars left to pay the PPD. Consequently, the potential to depool milk is increased, which creates disorderly marketing conditions.
2. Three of the non-MCP orders, Appalachian, Florida and Southeast do not have an adequate supply of producer milk within their marketing areas to meet consumer fluid milk demand. Supplemental milk must be transported into these markets to meet this demand. The supplemental milk is typically supplied from federal orders using MCP. The higher relative value of skim milk in MCP versus non-MCP markets increases the cost of supplemental milk for the non-MCP, deficit fluid milk markets. In addition, it decreases the incentive to move milk from reserve supply areas to deficit fluid milk markets. Both make it more costly and difficult to ensure consumers have access to an adequate supply of fluid milk.

**The Proposed Solution: Update the current milk component factors in the skim milk price formulas to reflect current actual composition of producer milk and provide for further periodic updates, as needed**

NMPF proposes to increase the skim component factors in the skim milk price formula to equal the weighted average nonfat solids, true protein and other solids factors for milk pooled on Federal Orders using data for the three years prior to implementation. Implementation of the new skim milk factors would occur 12 months after the Order

updating the skim factors. Due to the significant use of risk management programs by dairy producers and handlers, and the intricate nature of the transactions tied to the skim milk formulas, the new factors should not be implemented for a period of 12 months to allow the hedge transactions established prior to the change in the formulas to roll off.

To assure this misalignment in skim component factors does not recur, NMPF also proposes that the pricing factors be updated regularly, no less than every three years. However, no change shall occur until the weighted average of the milk components in the skim portion of milk pooled on federal orders for the prior three years changes by at least 0.7 percentage points. The updated component values would be calculated, and, if a change is warranted, also formally announced in February of such year, with the implementation of such changes occurring 12 months later, with March being the first month of implementation.

#### **Responses to 7 C.F.R. § 900.22 topics**

Following are NMPF's responses to the 7 C.F.R. § 900.22 questions to be answered by proponents in a Federal Milk Marketing Order hearing request:

*§900.22(a). Explain the proposal. What is the disorderly marketing condition that the proposal is intended to address?*

The proposal would increase the current milk component factors in the skim milk price formulas as follows:

Nonfat Solids: From 9.0 to 9.36 per hundred pounds of Class IV skim milk;  
Protein: From 3.1 to 3.35 per hundred pounds of Class III skim milk; and  
Other Solids: From 5.9 to 6.01 per hundred pounds of Class III skim milk.

The proposal would also establish a procedure to periodically review these factors in the future and make changes as necessary to maintain alignment with the evolving composition of producer milk.

The current milk component factors in the skim milk price formulas significantly underrepresent the current actual composition of producer skim milk, causing Class I milk prices to be lower relative to manufacturing milk class prices in all Federal Orders and for manufacturing class prices to undervalue producer milk in the non-MCP Federal Orders. This has increased the likelihood that milk will be depooled, particularly in the manufacturing-heavy Federal Orders, and it has reduced the revenue producers receive for all milk not paid for on a MCP basis. It has also eroded the incentive for local milk production in the three southeastern orders to expand to supply more of those deficit markets.

§900.22(b). *What is the purpose of the proposal?*

The purpose of the proposal is to maintain the milk component factors in the skim milk price formulas in alignment with the actual composition of producer milk using regular updates, thereby alleviating conditions that would tend to lead to disorderly marketing of milk.

§900.22(c). *Describe the current Federal order requirements or industry practices relative to the proposal.*

The Federal Order milk component factors currently found in the skim milk price formulas are 9.0 for nonfat solids per hundred pounds of Class IV skim milk, 3.1 for protein and 5.9 for other solids per hundred pounds of Class III skim milk. These factors have been unchanged since first implemented in Federal Order Reform in 2000 despite ample documentation that each of these factors has increased over the last two decades. Furthermore, the factors have never represented the actual composition of producer milk.

§900.22(d). *Describe the expected impact on the industry, including on producers and handlers, and on consumers.*

Increasing the skim milk component composition factors, as proposed, would have the initial price impacts of increasing Class I milk values in all Federal Order pools and increasing the values of manufacturing class milk in the four Federal Orders that do not use MCP. Revenues would be increased for all producers who pool milk on Federal Orders. By themselves, these changes would modestly increase milk costs to processors and potentially to consumers as well. Simply computing from the price formulas, the initial effect of the proposal, based on the average of monthly dairy product prices during 2019-2022, would be to increase the Class I price in all orders by \$0.55 per hundredweight. In the four non-MCP Federal Orders, the Class III price would increase by \$0.73 per hundredweight, and the Class IV price would increase by \$0.38 per hundredweight. Going forward, competitive market forces of supply and demand will tend to impact dairy product prices and premiums to mitigate this initial impact on producers and manufacturers and return milk prices received by dairy farmers to levels close to what they would receive in the absence of the proposed change.

§900.22(e). *What are the expected effects on small businesses as defined by the Regulatory Flexibility Act (5 U.S.C. §601-612)?*

Most businesses in the dairy industry meet the definition of a small business. Regulation of milk prices, and the resulting revenues and costs, are size-independent for producers and processors alike under Federal Orders. Most of the adjustments and impacts described under §900.22(d) above will apply in this context.

Producers that are small businesses will see increased revenues via marginally higher blend prices from this proposal. Class I processors that are small businesses and dairy product manufacturers that are small businesses in the four non-MCP Federal Orders will pay modestly higher skim milk prices but will benefit from a modestly improved ability to attract milk to their plants.

Producers, processors and manufacturers that forward contract milk will see little impact on their risk management decisions made prior to the implementation of the order changes if these changes are delayed by 12 months.

*§900.22(f). How would adoption of the proposal increase or decrease costs to producers, handlers, others in the marketing chain, consumers, the Market Administrator offices and/or the Secretary?*

See the response to question 900.22(d) above.

Producers will not experience higher costs as long as the implementation of the change does not impact hedges executed prior to implementation. Processors will see modestly higher skim milk costs. Most manufacturers are associated with MCP Federal Orders and will not be impacted by the proposed change since they are expected to pay the announced minimum prices for milk components when they are pooled. Processors may have some similar concerns to producers relative to forward contracting milk costs.

Consumers might see marginally higher prices. Other than needing to test producer milk for protein and other solids in the four non-MCP Federal Orders, if this is not already being done, there will be no impact on the Market Administrator offices or the Secretary.

*§900.22(g). Would a pre-hearing information session be helpful to explain the proposal?*

Given the comprehensive list of proposed changes, a pre-hearing information session may be helpful to explain this proposal. Accordingly, NMPF, as a petitioner, would support holding a pre-hearing information session.

### **Proposal 5: Update the Class I differential pricing surface throughout the United States**

NMPF also requests the Class I differentials be amended as part of the request to the Secretary to call a hearing pursuant to 7 C.F.R. § 900.1, *et seq.* Specifically, NMPF proposes to:

**Amend 7 C.F.R. § 1000.50 applicable to all federal milk marketing orders to provide:**

**§ 1000.50 Class prices, component prices, and advanced pricing factors.**

\* \* \* \* \*

(b) *Class I skim milk price.* The Class I skim milk price per hundredweight shall be the adjusted Class I differential specified in § 1000.52, ~~plus the adjustment to Class I prices specified in §§ 1005.51(b), 1006.51(b) and 1007.51(b) of this chapter,~~ plus the ...

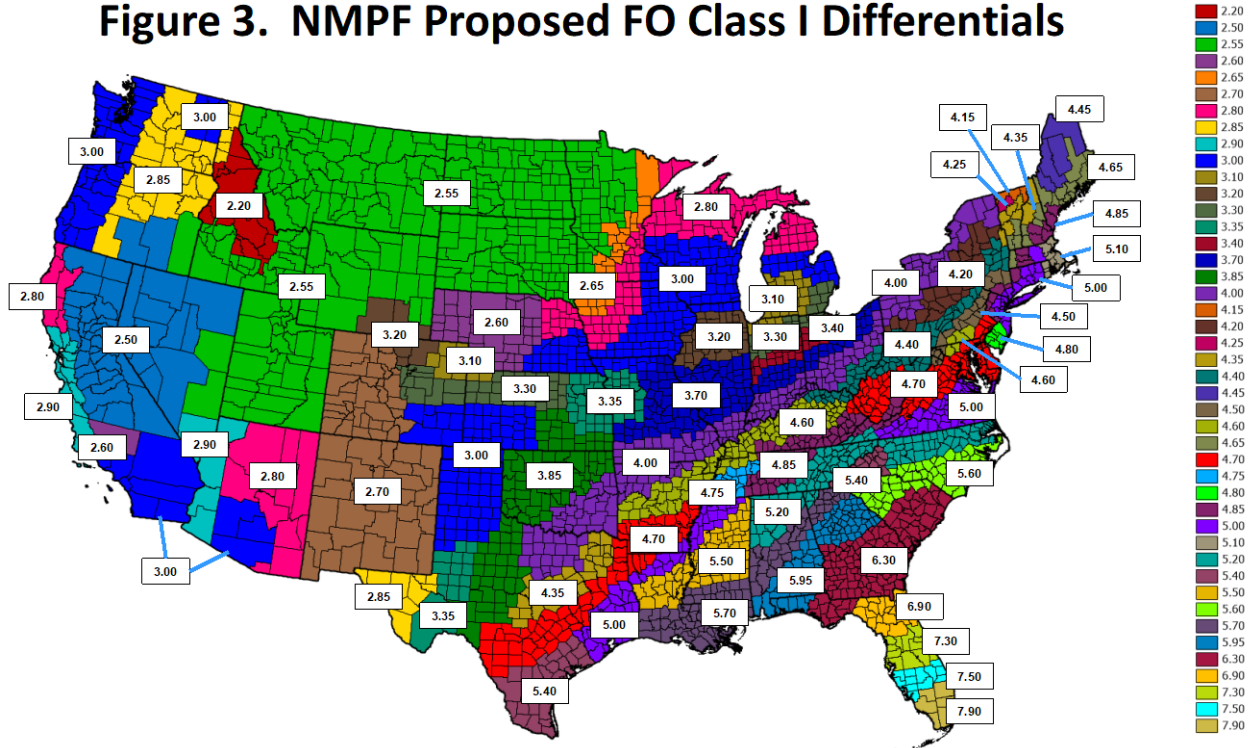
(c) *Class I butterfat price.* The Class I butterfat price per pound shall be the adjusted Class I differential specified in § 1000.52 divided by 100, ~~plus the adjustments to Class I prices specified in §§ 1005.51(b), 1006.51(b) and 1007.51(b) divided by 100,~~ plus the ...

**Amend 7 C.F.R. § 1000.52 Adjusted Class I differentials, applicable to all federal milk marketing orders, to provide:**

The Class I differentials adjusted for location to be used in § 1000.50(b) and (c), and listed in § 1000.52, shall be the proposed values specified in the colored-coded representation map shown below in Figure 3.

Note: §1005.51(b), §1006.51(b), and §1007.51(b), would be removed as part of this request, since §1000.52, as proposed, would include the full Class I differentials for the Appalachian, Florida, and Southeast Orders.

**Figure 3. NMPF Proposed FO Class I Differentials**



**Disorder caused by the current Class I differentials and current market conditions**

The majority of Federal Order Class I differentials have remained unchanged since Federal Order Reform, as reviewed and revised by Congress. The differentials in the Appalachian, Florida, and Southeast Orders were modestly updated in 2008.

The dynamic change the U.S. dairy industry has undergone since 2000 has affected the geographic pricing relationships among Federal Order prices. In particular, the increase in United States dairy exports to about 18 percent of its milk production from about 5 percent in 2000 has changed the value of milk at export locations such as California and other places across the country by adding another source of demand with additional transportation costs to distant locations to the traditional one of supplying fresh milk for Class I use.

Just as the production costs embedded in the Class II, III, and IV make allowances are out of date, so are the underlying cost assumptions in the Class I differentials. Since establishment of the current Federal Order Class I differentials, one of their key determinants, fuel costs and the basic per-mile costs of hauling milk, have increased. Truck driver per-day hours have been reduced, which has resulted in requiring more truck drivers and more rolling stock. Additionally, federal requirements for in-truck electronic driver and truck logs were implemented during this period. Higher capital investments have driven up overall milk hauling costs.

Other structural changes have increased both the costs and general availability of milk hauling: increased road tolls, restrictive and variable road weight limits, labor shortages, truck/trailer/tire and replacement parts shortages, and significant diesel fuel cost increases.

In the late 1990s and even into the middle 2000s, the cost of hauling milk was approximately \$1.70 to \$1.90 per loaded mile. This was equivalent to approximately \$0.347 to \$0.388 per hundredweight per 100 miles. Today the cost of hauling is between \$4.60 to \$5.00 per loaded mile, which is the equivalent of \$0.920 to \$1.000 per hundredweight per 100 miles.

Thus, the cost of hauling milk has almost tripled since the current Class I differentials were established. Compounding the expense, limited opportunities exist today for backhauls, which could reduce hauling costs. For example, in the Florida Order, the marketing area most distant from a reserve milk supply, backhauls of orange juice and orange juice concentrate used to be common. However, today, reduction in the Florida citrus industry and the availability of juice concentrate from other countries have nearly eliminated juice backhauls out of Florida. Where back hauls may still be an option, processors often foreclose the possibility by requiring tanker trailers remain dedicated to delivering milk and dairy products only.

Changes in the relative locations of farms and fluid milk processing plants have increased the cost of getting Class I milk to markets. Development in exurban fringes has displaced dairy farms. The location of milk production is increasingly distant from human population centers, while Class I processing plants remain in cities, due to the higher per unit costs of transporting packaged fluid milk relative to bulk, unprocessed milk. The miles that milk must travel to get from dairy farms to processing plants have increased.

The combination of increased miles milk must move to serve Class I markets and the significant increases in the per-mile cost of moving milk, is threatening the reliable supply of milk for Class I use in many Federal Orders. The Class I differentials, which continue to be the fundamental regulatory mechanism of the Federal Order program for

attracting an adequate supply of farm milk for fluid milk processing, remain largely unchanged since Federal Order Reform.

In addition to increases in milk hauling costs since 2000, all contributors to the cost of producing Grade A milk at the farm have also increased, and Class I prices are the only Federal Order prices in which the producer cost of production is taken into account, albeit in a limited fashion. The Federal Order base Class I differential has historically recognized that there has been a difference in the cost of producing milk solely for manufacturing use and the cost of producing for daily delivery to the Class I market. Over time, and with the Federal Order Reform changes in manufacturing class use prices eliminating any competitive milk procurement factor in a base milk price, the Class I differential base price now represents a modest nod to production costs at the producer level. Since 2000 those costs have risen far more than the limited increase in the base Class I differential, from \$1.60/cwt to \$2.20/cwt, embedded in the NMPF proposal. The base Class I differential also plays a role in reducing instances of class price inversions, the importance of which Department stressed in Federal Order Reform.

NMPF recognizes and supports USDA's long-standing policy of maintaining federally regulated prices as minimum prices and allowing market forces to fine-tune market prices. However, structural changes in the industry are limiting the reach and effectiveness of over-order prices. Larger fluid milk plants, higher costs of hauling, increased distances raw unprocessed milk must travel to supply Class I processing needs, and growing resistance by handlers to accept over-order prices, are leaving many costs of serving Class I processors uncovered. The result is disorderly market conditions. As costs increase, and the ability for over-order prices to keep up with these costs wane, pricing equity between competing processing plants is threatened. Worse, dairy farmers are subsidizing shortfalls of Class I prices to cover the full costs of supplying Class I milk to processors.

Taken together, milk transportation costs, producer production costs, and other factors, have created a market environment in which the Federal Orders operate that is antithetical to the goals of the Federal Order system: ensuring reliable supplies of milk for fluid processing, equitable treatment of producers and processors, and providing for the orderly marketing of milk. USDA must ameliorate the decay in the effectiveness of the Federal Orders system.

**The Proposed Solution: Update the current Class I differentials for all counties, parishes and cities in the contiguous United States**

NMPF's proposal to address the almost three-fold increase in milk hauling costs since 2000, and thereby to help alleviate the economic stresses on milk marketers who have accepted the responsibility of supplying the marketplace with milk for Class I use, is



to update the Adjusted Class I differentials for every county, parish and city currently listed in § 1000.52.

The method used to update Class I differentials follows the general process used during Federal Order Reform. This method also follows certain precepts of price alignment accepted by the Secretary in the southeastern Order pricing hearing held in 2007. In brief, proponents commissioned an update to the University of Wisconsin (previously Cornell University) national price surface model using more current model input data, including milk supplies, dairy product demand, cost of processing milk, and the cost of moving milk and dairy products. The model was greatly expanded to include many more supply and demand points as well as considerably more point-to-point road distances.

Proponents used the raw outputs from the University of Wisconsin model as a starting point. Proponents applied local knowledge of milk movements, plant locations, and historic price relationships to refine the model results and prepare a rational regulated Class I value surface, using time-honored Class I price alignment techniques and processes. NMPF's final Class I recommendations will deviate somewhat from the model results because of a variety of real-world milk movement considerations. Those deviations from the model results will be addressed at the hearing.

In all locations, as would be expected given the substantial increases in the costs of milk hauling, the recommended regulated Class I differential surface increased versus the current regulated Class I differentials. The tilt, or slope, of the price surface from reserve supply points to Class I demand points became steeper, and the geographic locations that represent reserve supply regions recognize the generally western-shifted U.S. milk supply. Similar to the general nature of the existing Class I differential price surface, the updated price surface slopes generally from lower values in the Northwest and West, areas of reserve supply, with increasing values toward the milk-deficit areas of the Southeast and Florida.

The updated Class I differentials, as proposed and through NMPF analysis, reflect less than the full cost of moving milk and thereby maintain the Department's long-standing principle of minimum prices. In developing this proposal, NMPF used the expertise of numerous individuals responsible for marketing milk in NMPF member cooperatives as well as others that have long-standing expertise in the national price surface. Their expertise was used with the model results to develop the proposed pricing surface that best fits the realities of today's marketplace. As such, the proposal does not follow the model's results in every instance as there are both positive and negative deviations from the model's results to better support a more orderly marketing system.

The results of the Proponent's study, analysis, and price alignment processes are included in Figure 3 shown above and discussed previously, which is the color-coded representation map that visibly presents the 3,108 counties, parishes and independent cities and each civil district's proposed Class I differential.

### **Responses to 7 C.F.R. § 900.22 topics**

Following are NMPF's responses to the 7 C.F.R. § 900.22 questions to be answered by proponents in a Federal Order hearing request:

*§900.22(a). Explain the proposal. What is the disorderly marketing condition that the proposal is intended to address?*

As detailed above, the proposal updates §1000.52 Adjusted Class I Differentials, as referenced in all Federal Orders for the 3,108 named counties, parishes and independent cities in the contiguous 48 states. This update will increase Class I differentials at all locations, in varying amounts.

Reevaluating and refining the Class I differentials will encourage orderly milk marketing because the differentials will more closely reflect the cost of moving milk from reserve supply areas to areas of demand. Class I differentials that better reflect the cost of moving milk and the locations of supply and demand for milk will benefit producers, handlers, and consumers.

The benefit to producers will come from enhanced Class I revenues relative to the regulated prices for the other manufacturing classes, which will incentivize the delivery of milk to Class I use. Handlers will benefit because the improved price gradient will make delivery of milk to plants distant from reserve supplies more appealing to producers, thus helping to assure these plants receive a sufficient quantity of milk. Consumers will benefit from enhanced orderliness in marketing of milk, which lowers transaction and supply costs, aids in retaining milk processing plants proximate to population centers and increases the integrity of the regulated pricing system in reflecting the increased acquisition costs of milk from reserve supply areas to population centers.

*§900.22(b). What is the purpose of the proposal?*

The purpose of the proposal is to ensure that processors of fluid milk products will be assured of receiving adequate supplies of producer milk by ensuring that suppliers receive adequate compensation to cover their increased costs of doing so.

§900.22(c). *Describe the current Federal order requirements or industry practices relative to the proposal.*

All Federal Orders contain the provisions of Class I differentials, and all Federal Orders use these funds to: (a) enhance pool revenues, (b) incentivize the movement of milk to Class I use, (c) provide a standard set of known regulated minimum prices charged to competing handlers, which together enhance orderly marketing.

§900.22(d). *Describe the expected impact on the industry, including on producers and handlers, and on consumers.*

Estimates by the various market administrators suggest the proposed Class I differentials, taken in isolation of any other proposals, will increase each order's announced uniform prices by \$0.25/cwt to \$1.78 /cwt, depending on each Federal Order's Class I utilization, *ceteris paribus*.

Updating Class I differentials is a part of NMPF's broader package of amendments to Federal Orders proposed by NMPF, which includes other proposals that will have the net impact of reducing manufacturing class prices, and thereby Class I prices as well. This makes it both challenging as well as not fully pertinent to quantify any change in costs of milk to handlers based on the proposed changes in Class I differentials alone. This also holds true for quantifying any potential change in prices of milk to consumers. Estimating the impact on consumer costs of dairy products is further complicated by the reality that consumer retail prices are generally believed to be poorly correlated with regulated announced minimum milk prices.

Bearing these limitations in mind, Table 2 provides an estimate of the national average Class I differentials for all Federal Orders. The estimate yields a national average Class I differential of \$2.57 per hundredweight with a proposed national average Class I differential of \$4.06 per hundredweight.

**Table 2. Current & Recommended Class I Differentials by Federal Order**

<b>Marketing Area</b>	<b>FO #</b>	<b>Current Class I Differential</b>	<b>NMPF Recommended Class I Differential</b>	<b>Difference</b>
<b>Northeast</b>	<b>1</b>	<b>\$2.88</b>	<b>\$4.64</b>	<b>\$1.76</b>
<b>Appalachian</b>	<b>5</b>	<b>\$3.17</b>	<b>\$5.10</b>	<b>\$1.93</b>
<b>Florida</b>	<b>6</b>	<b>\$5.23</b>	<b>\$7.07</b>	<b>\$1.84</b>
<b>Southeast</b>	<b>7</b>	<b>\$3.42</b>	<b>\$5.33</b>	<b>\$1.91</b>
<b>Upper Midwest</b>	<b>30</b>	<b>\$1.70</b>	<b>\$2.79</b>	<b>\$1.09</b>
<b>Central</b>	<b>32</b>	<b>\$2.03</b>	<b>\$3.24</b>	<b>\$1.21</b>
<b>Mideast</b>	<b>33</b>	<b>\$1.98</b>	<b>\$3.68</b>	<b>\$1.70</b>
<b>California</b>	<b>51</b>	<b>\$1.76</b>	<b>\$2.68</b>	<b>\$0.92</b>
<b>Pacific Northwest</b>	<b>124</b>	<b>\$1.85</b>	<b>\$2.92</b>	<b>\$1.07</b>
<b>Southwest</b>	<b>126</b>	<b>\$2.86</b>	<b>\$3.99</b>	<b>\$1.12</b>
<b>Arizona</b>	<b>131</b>	<b>\$2.08</b>	<b>\$2.86</b>	<b>\$0.78</b>
<b>Not Fed. Regulated</b>	<b>NR</b>	<b>\$2.06</b>	<b>\$3.33</b>	<b>\$1.26</b>
<b>Total</b>		<b>\$2.57</b>	<b>\$4.06</b>	<b>\$1.49</b>

§900.22(e). *What are the expected effects on small businesses as defined by the Regulatory Flexibility Act (5 U.S.C. §601-612)?*

As previously discussed, the majority of dairy farms are small businesses, and many fluid milk processors are as well. Federal Order regulation of milk prices, and the resulting revenues and costs do not respect business size. Regulated prices due to dairy farmer producers are not size specific. Regulated costs realized by handlers and processors of milk and dairy products are not size specific.

Small businesses that are dairy farms will mostly benefit by having their costs of supplying milk to fluid milk processors more fully covered. Small businesses that are fluid milk processors will benefit by having greater assurance of receiving an adequate supply of milk to produce their products.

§900.22(f). *How would adoption of the proposal increase or decrease costs to producers, handlers, others in the marketing chain, consumers, the Market Administrator offices and/or the Secretary?*

The proposed increase in Class I differentials should have no impact on the costs of producing milk to dairy farmers. As previously discussed, the impact on costs to

processors and consumers is not easily quantifiable due to the imprecise relationships between regulated milk prices, the price of milk at wholesale, and the prices of milk at retail.

The proposed increase in Class I differentials could result in improvements in other costs along the marketing chain since the improved price signals will tend to increase the orderliness of marketing and reduce uneconomic movements of milk.

Other non-fluid handlers and others in the marketing chain are not expected to be impacted.

Retail fluid milk prices are not regulated under Federal Orders. The indirect effect of Federal Orders on milk prices received by producers and therefore on wholesale prices of the basic dairy commodities will itself have an indirect effect on retail prices of fluid milk products. However, since Federal Orders do not directly affect the cost of producing milk or how milk is marketed, the initial impact of the proposed changes are expected to dissipate after just a few years. Higher Class I prices will encourage more milk to be produced, which will then cause Class I prices to decrease, along with manufacturing prices, while maintaining the increased difference between these two prices. The long-run impact on consumer prices of the proposed changes will be minimal.

Market Administrators and the USDA will not see a cost impact.

§900.22(g). *Would a pre-hearing information session be helpful to explain the proposal?*

Given the comprehensive list of proposed changes, a pre-hearing information session may be helpful to explain this proposal. Accordingly, NMPF, as a petitioner, would support holding a pre-hearing information session.

### **Concluding comment**

NMPF is requesting a national hearing to amend the uniform pricing provisions of all federal milk marketing orders that are contained within our entire “package” of recommendations. Just as the current set of uniform pricing provisions for all federal milk marketing orders was implemented as a package in 2000, it has also become uniformly outdated as a package more than 20 years later. It is truly NMPF’s desire for the Secretary to consider the collective package of recommendations and not to omit any specific recommendation. Incorporating the full package of recommendations balances both the advantages and disadvantages for all dairy stakeholders, dairy farmers, dairy processors, and consumers. Through NMPF’s own analysis and using professional

outside economic analysis, we have determined the net impact on retail dairy prices to be minimal for consumers.

**Taken together, NMPF is requesting the Secretary to call a hearing pursuant to 7 C.F.R. § 900.1, et seq., to amend 7 C.F.R. § 1000.50-52 applicable to all federal milk marketing orders to provide:**

**§ 1000.50 Class prices, component prices, and advanced pricing factors.**

\* \* \* \* \*

(b) ***Class I skim milk price.*** The Class I skim milk price per hundredweight shall be the adjusted Class I differential specified in § 1000.52, ~~plus the adjustment to Class I prices specified in §§ 1005.51(b), 1006.51(b) and 1007.51(b) of this chapter,~~ plus the simple average **higher** of the advanced pricing factors computed in paragraph (q)(1) and (2) of this section rounded to the nearest cent, ~~plus \$0.74 per hundredweight.~~

(c) ***Class I butterfat price.*** The Class I butterfat price per pound shall be the adjusted Class I differential specified in § 1000.52 divided by 100, ~~plus the adjustments to Class I prices specified in §§ 1005.51(b), 1006.51(b) and 1007.51(b) divided by 100,~~ plus the ...

\* \* \* \* \*

(f) ***Class II nonfat solids price.*** The Class II nonfat solids price per pound, rounded to the nearest one-hundredth cent, shall be the Class II skim milk price divided by 9 **the applicable nonfat solids component factor described in § 1000.51.**

\* \* \* \* \*

(i) ***Class III skim milk price.*** The Class III skim milk price per hundredweight, rounded to the nearest cent, shall be the protein price per pound times 3.1 **the applicable protein component factor described in § 1000.51** plus the other solids price per pound times 5.9 **the applicable other solids component factor described in § 1000.51.**

\* \* \* \* \*

(k) ***Class IV skim milk price.*** The Class IV skim milk price per hundredweight, rounded to the nearest cent, shall be the nonfat solids price per pound times 9 **the applicable nonfat solids component factor described in § 1000.51.**

(l) **Butterfat price.** The butterfat price per pound, rounded to the nearest one-hundredth cent, shall be the U.S. average ~~NASS~~ AA Butter survey price reported by the Department for the month, less ~~17.15~~ **21.00** cents, with the result multiplied by 1.211.

(m) **Nonfat solids price.** The nonfat solids price per pound, rounded to the nearest one-hundredth cent, shall be the U.S. average ~~NASS~~ nonfat dry milk survey price reported by the Department for the month, less ~~16.78~~ **21.00** cents ~~and multiplying the result~~ **with the result multiplied** by 0.99.

(n) **Protein price.** Strike all subsequent parts of this paragraph and insert in lieu thereof:

**(1) Subtract 24.00 cents from the from the U.S. average survey price for 40-lb. block cheese reported by the Department for the month and multiply the result by 1.383;**

**(2) Add to the amount computed pursuant to paragraph (n)(1) of this section an amount computed as follows:**

- (i) Subtract 24.00 cents from the U.S. average survey price for 40-lb. block cheese reported by the Department for the month and multiply the result by 1.572; and**
- (ii) Subtract 0.9 times the butterfat price computed pursuant to paragraph (l) of this section from the amount computed pursuant to paragraph (n)(2)(i) of this section; and**
- (iii) Multiply the amount computed pursuant to paragraph (n)(2)(ii) of this section by 1.17.**

(o) **Other solids price.** The other solids price per pound, rounded to the nearest one-hundredth cent, shall be the U.S. average ~~NASS~~ dry whey survey price reported by the Department for the month minus ~~19.91~~ **23.00** cents, with the result multiplied by 1.03.

\* \* \* \* \*

(q) **Advanced pricing factors.** ...

(1) ...

(i) ...

- (ii) Multiply the protein price computed in paragraph (q)(1)(i) of this section by ~~3.1~~ **the applicable protein component factor described in § 1000.51**;
  - (iii) Multiply the other solids price per pound computed in paragraph (q)(1)(i) of this section by ~~5.9~~ **the applicable other solids component factor described in § 1000.51**; and
  - (iv) ...
- (2) ...
- (i) ...
  - (ii) Multiply the nonfat solids price computed in paragraph (q)(2)(i) of this section by ~~9~~ **the applicable nonfat solids component factor described in § 1000.51**.
- (3) An advanced butterfat price per pound rounded to the nearest one-hundredth cent, shall be calculated by computing a weighted average of the 2 most recent U.S. average-NASS AA Butter survey prices announced before the 24th day of the month, subtracting ~~17.15~~ **21.00** cents from this average, and multiplying the result by 1.211.

**§ 1000.51 ~~Reserved~~ Milk Component Factors**

- (1) Upon the implementation of this Order, the component factor for protein, other solids and nonfat solids shall be the following:**
  - (i) Protein 3.1;**
  - (ii) Other solids 5.9; and**
  - (iii) Nonfat solids 9.0.**
  
- (2) Beginning the first day of the 12th month after implementation of this Order, the component factors for protein, other solids and nonfat solids shall be the following:**
  - (i) Protein 3.35;**
  - (ii) Other solids 6.01; and**
  - (iii) Nonfat solids 9.36.**
  
- (3) By February 28th of each year beginning one year after the implementation of paragraph 2 of this section, the component factors in**



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**paragraph 2 of this section will be updated to the most recent three year-weighted average component tests of producer milk in all Orders, if any one factor is at least 0.7 percentage points higher than those currently in effect.**

**(i) Implementation of the updated component factors under this section shall be announced no later than 5 days after the calculation that triggers a change and shall become effective the first day of March of the following year.**

**§ 1000.52 Adjusted Class I differentials, applicable to all federal milk marketing orders, to provide:**

The Class I differentials adjusted for location to be used in § 1000.50(b) and (c), and listed in § 1000.52, shall be the proposed values specified in the colored-coded representation map shown above in Figure 3.

The proponents wish to thank Secretary Vilsack and the Department in advance for consideration of this request.

Very truly yours,



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Federal Milk Market Administrators

# Calculating Class III Price: Details



*Monthly commodity prices are announced on or before the 5th day of the following month.  
Class prices are announced as dollars per hundredweight. CWT= hundredweight, 100 pounds.*

## Formula Details

**1**     **\$0.1991** = Manufacturing cost to produce 1 pound of dry whey, excluding cost of raw milk (\$/lb).  
**1.03** = Factor representing pounds of dry whey that can be made from 1 pound of other solids (lb dry whey/lb other solids).

**2**     **\$0.1715** = Manufacturing cost to produce 1 pound of butter, excluding cost of raw milk (\$/lb).  
**1.211** = Factor representing pounds of butter that can be made from 1 pound of butterfat (lb butter/lb butterfat).

**3**     **1.17** = Assuming standard cwt of milk components (3.5 lb butterfat and 2.99 lb protein), 1.17 pounds of butterfat are associated with 1 pound of protein.

**\$0.2003** = Manufacturing cost to produce 1 pound of cheese, excluding cost of raw milk (\$/lb).

**1.383** = Factor representing pounds of cheese that can be made from 1 pound of protein (lb cheese/lb protein).

**1.572** = Factor representing pounds of cheese that can be made from 1 pound of butterfat (lb cheese/lb butterfat).

**0.9** = Factor accounting for the butterfat retained in the cheese manufacturing process (90 lb butterfat in cheese/cwt of butterfat used). Accounts for the fat lost in the whey stream.

**4**     **3.1** = Pounds of protein in 100 pounds of skim milk (lb protein/cwt skim).

**5.9** = Pounds of other solids in 100 pounds of skim milk (lb other solids/cwt skim).

**5**     **0.965** = 96.5 pounds of skim in 100 pounds of milk (cwt skim/cwt milk).

**3.5** = Pounds of other solids in 100 pounds of skim milk (lb butterfat/cwt milk).

*For more information on the Price Formulas, visit*

**[www.ams.usda.gov/resources/price-formulas](http://www.ams.usda.gov/resources/price-formulas)**

*For more information on Advanced Prices & Pricing Factors and Class & Component Prices, visit* **[www.ams.usda.gov/rules-regulations/mmr/dmr](http://www.ams.usda.gov/rules-regulations/mmr/dmr)**

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# Calculating Class IV Price: Details



*Monthly commodity prices are announced on or before the 5th day of the following month. Class prices are announced as dollars per hundredweight. CWT= hundredweight, 100 pounds.*

## Formula Details

- 1**     **\$0.1715** = Manufacturing cost to produce 1 pound of butter, excluding cost of raw milk (\$/lb).  
**1.211** = Factor representing pounds of butter that can be made from 1 pound of butterfat (lb butter/lb butterfat).
- 2**     **\$0.1678** = Manufacturing cost to produce 1 pound of NFDM, excluding cost of raw milk (\$/lb).  
**0.99** = Factor representing pounds of NFDM that can be made from 1 pound of nonfat solids (lb NFDM/lb nonfat solids).
- 3**     **9.0** = Factor representing pounds of nonfat solids found in a standard 100 pounds of skim milk (lb nonfat solids/cwt skim).
- 4**     **0.965** = 96.5 pounds of skim in 100 pounds of milk (cwt skim/cwt milk).  
**3.5** = 3.5 pounds of butterfat in 100 pounds of milk (lb butterfat/cwt milk).

*For more information on the Price Formulas, visit*

**[www.ams.usda.gov/resources/price-formulas](http://www.ams.usda.gov/resources/price-formulas)**

*For more information on Advanced Prices & Pricing Factors and Class & Component Prices, visit **[www.ams.usda.gov/rules-regulations/mmr/dmr](http://www.ams.usda.gov/rules-regulations/mmr/dmr)***

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