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PRESENTATION

TO THE NATIONAL DAIRY SUMMIT

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Thank you Senator Leahy for the kind introduction. Secretary Espy and leaders of the dairy industry, thank you for the invitation to provide a few comments concerning federal milk marketing orders and issues revolving around the reform of milk marketing order systems. If one combines the milk marketed under federal milk marketing orders with those marketed under the California milk marketing order, roughly 355 million pounds of milk a day are directly regulated through marketing order mechanisms. Those 355 million pounds are delivered to over 2000 plants and bottled, processed, and manufactured into thousands of individual products and distributed to hundreds of thousands of retail and institutional outlets. The fact that this highly perishable product in volumes of this magnitude is processed, distributed, and sold daily is a stark testimony to how well the marketing order systems work in everyday milk distribution.

If orders do work so well, why are there so many calls for milk marketing order reform? Calls for order reform are just part of the territory that goes with marketing order systems. In the simplest sense, a milk marketing order is a legal instrument issued to regulate, at a minimal level pricing, transactions between producers and buyers of Grade A milk in a specific geographic area. Milk marketing orders grant the police power of the state to producers to direct, and sometimes constrain the actions of individual milk production, processing, or marketing firms. Individual firm profits are sometimes constrained in order to have the composite performance of the milk delivery system be consistent with broad social performance goals. Given the application of police power that restricts the actions of individual firms, it is no wonder that milk marketing orders are controversial and their operation and details are often under question.

Calls for reform of milk marketing orders in a simplistic sense come with two basic purposes. Some calls for order reform are really calls for order elimination. Another set of calls are for reforms that will increase the dynamic efficiency goals of federal orders in ways that are consistent with the public interest objectives specified for the orders. It will be clear from my comments today, that my discussion on milk marketing order reforms puts me into the latter reform camp, i.e., one who believes that orders do lead to more dynamically efficient milk marketing systems. Therefore, my comments should be taken within that context.

Milk marketing orders have been reviewed, dissected and analyzed greatly in the past few years. As have all industry observers, I have had time to reflect on order performance after these discussions. In my analysis, there are three driving forces behind the calls for marketing order reform. Until these are recognized and openly debated, marketing order debates will probably continue to focus on surrogate issues.

<u>The first market force driving federal order reform is market price instability</u>. The instability being experienced by market prices in the order is not a direct consequence of federal order performance but is because the price support program no longer provides the underlying stability for the U.S. milk marketing system. The current price instability is extremely disruptive to handlers' pricing practices and can put dairy products at strategic disadvantage in the modern food system. Unstable prices also lead to aberrant market order behaviors such as that seen in the upper Midwest and Chicago marketing orders in April and May of this year when massive quantities of milk were depooled.

<u>The second major force for market order reform involves the significant increase in high value manufacturing milk in the federal order system</u>. The federal orders were conceived as mechanisms to provide an adequate supply and orderly marketing of fluid grade milk for fluid consumption. Manufacturing in federal orders is a necessary condition for orderly marketing by providing for balancing of supply and demand variations in a market. Increasingly, federal milk marketing orders have Grade A milk dedicated to manufacturing of cheese. The cheese plants and the cheese markets have two characteristics which make them problematic in federal orders. The <u>first</u> is that many modern cheese plants do not provide a fluid milk market balancing function; and, <u>second</u>, the value in the marketplace of cheese is sufficient to bind raw milk supplies to cheese plants in such a way so that those supplies are not available for servicing fluid milk marketing needs.

<u>The third driving force behind calls for order reform is that fact that the federal milk marketing order system is no longer spatially or economically separated from California milk marketing</u>. The two systems are linked in many respects. California and other West Coast production provide true surplus product quantities which affect the national price for manufactured products including cheese. Therefore, the operation of the California milk marketing system directly impacts the entire pricing structure of the federal order systems. The two marketing order systems are inexorably linked.

In my opinion these three forces are so fundamental, that successful operation of an orderly U.S. milk marketing system requires that milk marketing order reforms take place not just in the federal milk marketing system but in State order systems also.

It is time to switch from analysis to advocacy. As a professor at a land grant university with no income directly tied to order rules or operations, I can suggest possible reforms without any vested financial interest. A debate on one or several of the following suggestions, might help move federal order reform forward.

First, the implications from these basic forces are not handled well by individual order amendments and hearing processes. National hearings and/or coordinated actions across all orders such as the current Class IIIa recommended decision are often a superior way to go. Eventually, California decisions can be "blended" with changes made through national federal order decisions. The recent Class IIIa recommended decision and the recent California Class I commodity reference pricing decision are starting the process of moving the order system toward harmony. Recent recommended decisions appear to be moving current order systems in the right direction.

Second, to have a meaningful order system, rewards from operations should be directly linked to those who take responsibilities, i.e., pay (through pool access) for only those who play (through commitments to service the market). Major consolation of orders, binding performance requirements and provisions for inter-order revenue pooling are all supported by adopting the principle of linking pool access to pool responsibility.

Third, time has come to seriously consider decoupling the fluid milk marketing system from gyrations of short term components values generated from the manufacturing markets. As the U.S. dairy industry is irrevocably cast into international markets, this decoupling becomes even more critical. A closely related issue is the need to re-establish the order system as a fluid market system. To that end, some specific suggestions include: (1) eliminating a cheese market farm milk price as the basic mover price in the order system - the basic price mover should reflect a true surplus price for milk that does not have higher value use; and (2) isolating cheese milk supplies in the orders. Two approaches could be used. Either cheese milk could be depooled or it could be classified as a higher value use product and differentially priced.

In closing, recent changes and order amendment activities have been positive and useful in addressing some of the fundamental driving forces. However, milk marketing order reform has a long way to go. I would hope that the entire set of stakeholders with vested interests in having a dynamically efficient and fair milk marketing order system will reach consensus on the need for some basic reforms. A strong consensus for reform will be necessary to overcome the considerable inertia of vested interests in current order rules and the movements dedicated to eliminate milk marketing orders.

Again, I would like to thank Senator Leahy and Secretary Espy for the opportunity to present my perspectives on needed reforms of this critical and valuable part of the U.S. dairy system.