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Dairy Policy Issues

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SUMMARY

Three major dairy policy issues have captured the attention of the 106th Congress—federal financial assistance for dairy farmers; implementation by USDA of changes to federal farm milk pricing regulations; and regional debates over the market effects of dairy compacts.

To help mitigate the effects of volatile farm milk prices, a provision for $443 million in emergency dairy payments is contained in the Senate-passed version of the FY2001 agriculture appropriations bill (H.R. 4461). The Senate bill also contains a dairy producer supported amendment that would prohibit FDA from allowing "dry ultra-filtered (UF) milk" as an allowable ingredient in the production of cheese. Conference on the measure is expected in September.

The dairy price support program, which authorizes USDA to purchase surplus dairy products to support farm milk prices, was extended one year through December 31, 2000, in the FY2000 agriculture appropriations act (P.L. 106-78). A provision in the House-passed version of the FY2001 agriculture appropriations bill (H.R. 4461) would extend the program through 2001.

A separate milk pricing tool, federal milk marketing orders, requires processors to pay a minimum price for farm milk depending on how the milk is used. Farmer groups in the Upper Midwest contend that pricing policy is in need of major reforms. Many dairy processors contend that orders are market-distorting and should be gradually eliminated. Eastern and Southern dairy farmers oppose major changes to the current order system.

On January 1, 2000, as required by law, USDA began implementing its final rule to consolidate the number of marketing order regions from 31 to 11 and make major changes to the federal pricing system. Last year, USDA released a preliminary proposal that included two options for pricing fluid farm milk under the consolidated orders. One option (1A), supported by Eastern and Southern farm groups, left prices little changed from current policy, while the other option (1B), which USDA and Midwest dairy farmers preferred, would have reduced minimum farm prices for fluid milk in many regions.

USDA originally opted for a modified version of Option 1B in its final decision. However, Congress passed a measure (H.R. 3428) as part of the FY2000 consolidated appropriations act (P.L. 106-113) which required USDA to adopt Option 1A as the new method for pricing fluid farm milk, effective January 1, 2000. The law requires USDA to reconsider how it prices farm milk used in manufactured products by the end of 2000. It also authorizes a pilot program that will allow dairy farmers and processors to enter into forward price contracts, effective August 4, 2000 through December 31, 2004.

The New England states have temporary authority for a regional Northeast dairy compact, which allows the region to establish minimum fluid milk prices above the minimum federal level. A provision in P.L. 106-113 extends authority for the Northeast compact through Sept. 30, 2001. Processors and Upper Midwest producers oppose compacts, saying that they distort dairy markets. The Northeast Compact Commission has finalized a program that it says will discourage any potential overproduction of milk that might result from the higher farm milk prices mandated by the compact.

MOST RECENT DEVELOPMENTS

On, July 20, 2000, the Senate completed action on its version of the FY2001 agriculture appropriations bill (H.R. 4461), which includes a provision for supplemental direct payments of $443 million for dairy farmers. The House-passed version of H.R. 4461 does not contain any emergency dairy assistance. Emergency payments of $200 million in FY1999 and $125 million in FY2000 were provided by Congress to dairy farmers to supplement farm income in response to volatile farm milk prices. The Senate-passed version also contains a dairy-producer supported amendment that would prohibit the Food and Drug Administration from issuing any regulations that would allow "dry ultra-filtered (UF) milk" as an allowable ingredient in the production of cheese. The House-passed version also includes an extension of the dairy price support program through 2001. (The Senate-reported version of the bill also included an extension of the price support program, but the provision was inadvertently deleted in the printing of the Senate-passed bill.) Conference on the measures is expected in September.

USDA continues to implement legislative mandates (P.L. 106-113/H.R. 3428) for modifying federal pricing policy for farm milk under federal milk marketing orders. P.L. 106-113 authorized a temporary pilot program to allow individual dairy farmers or their cooperatives to enter into forward price contracts with processors to mitigate the effects of farm milk price volatility. USDA issued a final rule on this pilot program on July 18, 2000. The program will be effective from August 1, 2000, through December 31, 2004.

BACKGROUND AND ANALYSIS

Emergency Federal Assistance for Dairy Farmers

Over the course of the last two fiscal years (FY1999 and FY2000), Congress has provided just over $21 billion in emergency spending for USDA programs, primarily to help farmers recover from low farm commodity prices and natural disasters. The majority of these funds has been for supplemental direct farm payments made to producers of certain commodities, primarily grains and cotton, but also including soybeans, peanuts, tobacco and milk. Dairy farmers received supplemental payments of $200 million in FY1999 as provided by the Omnibus Consolidated and Emergency Supplemental Appropriations Act, 1999 (P.L. 105-277), and $125 million as provided in the FY2000 agriculture appropriations act (P.L. 106-78).

The Senate-passed version of the FY2001 agriculture appropriations bill (H.R. 4461) contains a provision for supplemental direct payments of $443 million for dairy farmers in FY2000. The House-passed bill (H.R. 4461) contains no comparable provisions. Conference on the two measures is expected in September.

The emergency dairy payments in the Senate-passed bill would be made to any producer who received a supplemental dairy payment under the previous round of payments under P.L. 106-78. The amount of the payment would be equal to 35% of the difference between the market value of 2000 production and the previous 5-year average value of production. The Senate-passed bill also requires the same terms and conditions for these payments as the previous two rounds of payments. Payments were made on a milk producer's first 2.6 million pounds of milk production in either 1998 or 1997 at a payment rate of 22.5 cents per cwt., not to exceed $5,000 per farm.

For more information on supplemental farm assistance, see CRS Report RS20416, *Emergency Farm Assistance in FY2000 Appropriations Acts*, and CRS Report RL30501, *Appropriations for FY2001: U.S. Department of Agriculture and Related Agencies.*

Prohibition on Dry Ultra-Filtered Milk in Cheese Production. The Senate-passed FY2001 appropriations bill also contains an amendment that would prohibit the Food and Drug Administration from issuing any regulations that would allow "dry ultra-filtered (UF) milk" as an ingredient in the production of cheese. Dry UF milk is a product, in which certain milk proteins necessary for cheese production are selectively included and all of the water is removed from the milk, thus making it efficient to ship long distances. Dairy farmer groups, which support this amendment, are concerned that imports of dry UF milk would displace domestic milk used for cheesemaking and would depress farm milk prices. Currently, neither wet nor dry UF milk is allowed as an ingredient in U.S. cheese production. Cheese processors had petitioned FDA for a change in standards to allow UF milk in cheese production. Following the criticism of the proposal by dairy producer groups, processors dropped their request for the use of dry ultra-filtered milk. The amendment to the Senate-passed version of H.R. 4461 would also require the General Accounting Office to conduct a study within 90 days of enactment to determine the quantity and use of imported ultra-filtered milk.

Dairy Price Support Program

The Agricultural Act of 1949 established the dairy price support program by permanently requiring the U.S. Department of Agriculture (USDA) to support the farm price of milk. Since 1949, Congress has regularly amended the program, usually in the context of multi-year omnibus farm acts and budget reconciliation acts. Current authority for the dairy price support program is provided by the Federal Agriculture Improvement and Reform Act of 1996 (P.L. 104-127, the 1996 farm bill).

Historically, the supported market price for milk is intended to protect farmers from price declines that might force them out of business and to protect consumers from seasonal imbalances of supply and demand. USDA's Commodity Credit Corporation (CCC) supports milk prices by its standing offer to purchase surplus nonfat dry milk, cheese, and butter from dairy processors. Government purchases of these storable dairy products indirectly support the market price of milk for all dairy farmers. Prices paid to the processors are set administratively by USDA at a level that should permit them to pay dairy farmers at least the federal support price for their milk.

During the 1980s, the dairy sector experienced a chronic surplus, much of which was acquired by the CCC. At their peak in fiscal year 1983, government surplus acquisitions represented about 12% of all U.S. milk output, at a net outlay cost of $2.6 billion. A series of legislative actions since then reduced the dairy support price from its peak of $13.10 per cwt. in 1983, to $10.10 per cwt. from 1990 through 1995, which helped reduce CCC

Table 1. Commodity Credit Corporation Milk Price Support Operations 1979/80-1999/2000

Marketing year[a]	Net Removals Milk Equivalent (billion lbs.)[b]	Net Outlays (million $)	CCC Support Price ($ per cwt.)	CCC Purchases as Percentageof Production
1979-80	8.2	1,280	11.49-12.36	6.4%
1980-81	12.7	1,975	13.10	9.6
1981-82	13.8	2,239	13.49-13.10	10.2
1982-83	16.6	2,600	13.10	12.0
1983-84	10.4	1,597	13.10-12.60	7.6
1984-85	11.5	2,181	12.60-11.60	8.2
1985-86	12.3	2,420	11.60	8.5
1986-87	5.4	1,238	11.60-11.35	3.8
1987-88	9.7	1,346	11.10-10.60	6.7
1988-89	9.6	712	10.60-11.10	6.7
1989-90	8.4	505	10.60-10.10	5.7
1990-91	10.4	839	10.10	7.0
1991-92	10.1	232	10.10	6.7
1992-93	7.6	253	10.10	5.0
1993-94	4.2	158	10.10	2.8
1994-95	2.9	4	10.10	1.8
1995-96	0.1	-98	10.10-10.35	0.1
1996-97	0.7	67	10.20	0.4
1997-98	0.7	291	10.20-10.05	0.4
1998-99	0.3	480(c)	10.05-9.90	0.2
1999-2000(d)	0.8	685	9.90	0.5

Source: U.S. Department of Agriculture, Farm Service Agency, selected publications.

a. The marketing year is October 1-September 30.
b. The milk equivalent is the pounds of fluid milk used to manufacture cheese and butter, on a milkfat basis.
c. Includes $200 million emergency "Market Loss" payments authorized by P.L. 105-277.
d. USDA estimate, includes $125 million in net outlays for market loss payments authorized by P.L. 106-78.

acquisitions to under 5% of production in more recent years. Consequently, program outlays dropped as well — to an annual average of $130 million between FY1992 through FY1998 (see table 1).

Price Support Action and Proposals

The 1996 farm bill (P.L. 104-127) retained the level of support at the then-current price of $10.35 per cwt. for the remainder of 1996, but then required it to fall to $10.20 on January 1, 1997, to $10.05 on January 1, 1998, and to $9.90 on January 1, 1999. In order to achieve this support price, USDA has set its product purchase prices at 65 cents per lb. for butter, $1.01 for nonfat dry milk, $1.10 per lb. for block cheddar, and $1.07 per lb. for barrel cheese. P.L. 104-127 originally required the dairy price support program to terminate at the end of 1999. However, a provision in the FY2000 agriculture appropriations act (P.L. 106-78), signed into law on October 22, 1999, extended program authority through 2000. The House-passed and Senate-reported versions of the FY2001 agriculture appropriations bill (H.R. 4461) contain an additional one-year extension of the dairy price support program, through calendar year 2001. (Due to a technical error, the provision was inadvertently deleted from the Senate bill following passage, and therefore does not appear in the printed version of the bill.)

Earlier this year, legislation (H.R. 3864) was introduced to increase the level of dairy price support from the current $9.90 per cwt. to $12.50 per cwt. and also to extend program authority through 2002. Supporters of the bill say that the current level of support is too low to help farmers when milk prices are volatile. Opponents contend that the higher support price would lead to overproduction of milk and would significantly increase federal costs through additional purchases of surplus dairy products.

Federal Milk Marketing Order Issues

Background

The farm price of approximately three-fourths of the nation's fluid milk is regulated under federal milk marketing orders. Federal orders, which are administered by the U.S. Department of Agriculture (USDA), were instituted in the 1930s to promote orderly marketing conditions by, among other things, applying a uniform system of classified pricing throughout the market. Unlike the dairy price support program, (see "Dairy Price Support Program" below) federal milk marketing orders are permanently authorized and therefore do not require periodic reauthorization. Some states, California for example, have their own milk marketing regulations in place of federal rules. Producers in federal marketing order regions are affected by two fundamental marketing order provisions: the classified pricing of milk according to its end use, and the pooling of receipts to pay all farmers a blend price.

Proponents of federal orders argue that orders are necessary because dairy farmers have a competitive disadvantage vis-a-vis dairy handlers (processors) when it comes to determining prices that farmers receive for their raw milk. Federal orders regulate handlers that sell milk or milk products within an order region by requiring them to pay not less than an established minimum price for the Grade A milk they purchase from dairy producers, depending on how the milk is used. This classified pricing system requires handlers to pay a higher price for milk used for fluid consumption (Class I) than for milk used in manufactured dairy products such as yogurt, ice cream, cheese, butter and nonfat dry milk (Class II, Class III and Class IV products).

Blend pricing allows all dairy farmers in the order region to pool their milk receipts and then be paid a single price for all milk based on order-wide usage (a weighted average of the three usage classes). Paying all farmers a single blend price is seen as an equitable way of sharing revenues for identical milk directed to both the higher-valued fluid market and the lower-valued manufacturing market.

Manufactured class (Class II, III and IV) prices generally are the same in all orders nationwide and are calculated monthly by USDA based on current market conditions. The Class I price for milk used for fluid consumption varies from area to area and in recent years has been a source of regional controversy. Class I prices are determined by adding to a monthly base price, a “Class I differential” that generally rises with the geographical distance from the Upper Midwest, traditionally a milk surplus region.

Class I differential pricing is a mechanism designed to ensure that local farmers receive a guaranteed minimum price for their fluid milk that generally is high enough to encourage adequate production. Local dairy farmers are protected by the minimum price rule against lower-priced milk that might otherwise be hauled into their region. Although a primary goal of federal milk marketing orders is to facilitate the flow of milk from surplus production regions to deficit regions, some dairy producer groups contend that federal order pricing policy actually discourages such movement of milk.

In recent years, producers in the Upper Midwest (Wisconsin and Minnesota) have maintained that federal orders are in need of reform, while many dairy processors contend that orders are market-distorting and should be gradually eliminated. These critics contend that the Class I differentials in some regions are too high and encourage milk production in higher cost of production regions (particularly the Northeast and Southeast) at the expense of traditional dairy states such as Minnesota and Wisconsin. As a result, they say, these regions are becoming less dependent on the Upper Midwest for supplemental supplies in the short production months. Since processors must pay as much for milk shipped in from surplus regions as they would for local production, the critics maintain that there is no economic incentive to bring in milk from other regions, even if that region has a lower cost of production.

Milk producer groups in the Northeast and Southeast generally support the current order system and want Class I differentials to remain no lower than their current levels. Eastern producers contend that any reduction in Class I differentials would reduce their incomes and force smaller farmers out of business. In fact, many Northeast and Southeast producers argue that Class I differentials are not high enough, which led to the formation of the Northeast Dairy Compact and a proposal for a Southern compact, to mandate fluid milk prices that are higher than the minimum federally mandated level. (See "Dairy Compacts" below for more information on the Northeast and Southern dairy compacts.) For more detail on how federal milk marketing orders operated prior to the implementation of the new modifications discussed below, see CRS Report 97-322, *Federal Milk Marketing Orders: A Primer*.

USDA Final Rule on Milk Marketing Order Reform

Background and Summary of Action. Although Upper Midwest farm groups sought legislative changes to the federal order pricing system in the first half of the 1990s, the lack of consensus among regions precluded any mandated changes to federal orders in the omnibus 1996 farm bill. However the 1996 farm law (P.L. 104-127) did require USDA to reduce the number of milk marketing orders — to at least 10 but no more than 14 from the current 31 orders — and originally gave USDA until April 4, 1999 to administratively achieve this goal. (The deadline date was extended until October 1, 1999 by the FY1999 omnibus appropriations act (P.L. 105-277). When USDA released its final decision on March 31, 1999, it not only proposed a consolidation of orders from 31 to 11, but also proposed comprehensive changes to milk pricing policy by revising how Class I (fluid) milk should be priced and devising a substitute for the basic formula price for farm milk. The text of the final decision can be found in the *Federal Register* of April 2, 1999, or on the USDA website at. [http://www.ams.usda.gov/fmor/final_order.htm].

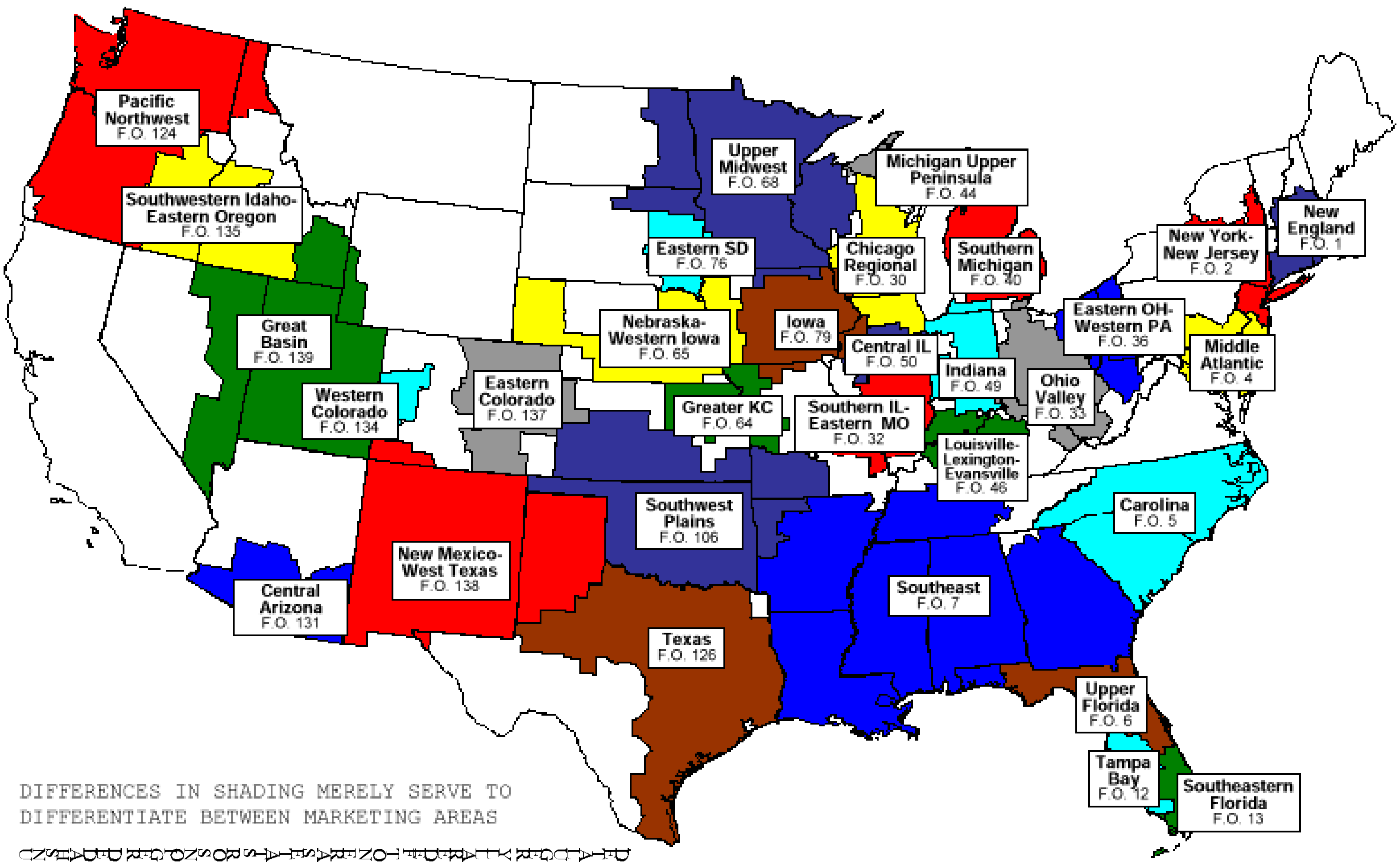
The final decision had to be approved by two-thirds of voting farmers in each of the consolidated regions before it could become effective, which farmers did in all of the consolidated regions in early August 1999. If farmers had rejected the final decision, it would have meant the end of federal milk marketing order regulation in that region. Once the final decision was approved by farmers, it was published in the *Federal Register* and became a final order or rule, which USDA planned to implement on the statutory implementation date of October 1, 1999. However, a legal challenge posed by Northeast dairy farmers and affirmed by a Vermont federal district court temporarily postponed the implementation of a final decision. Current law extends USDA's deadline date for implementation by the duration of any injunction or restraining order.

Following the legal challenge, Congress agreed to legislation (H.R. 3428) as part of the FY2000 consolidated appropriations bill (P.L. 106-113, H.R. 3194) which was signed into law on November 30, 1999. It required USDA to implement an alternative option (1A) that maintains minimum prices for fluid-use farm milk close to their current levels. (See "Legislative Action to Mandate Option 1A" below for more information.)

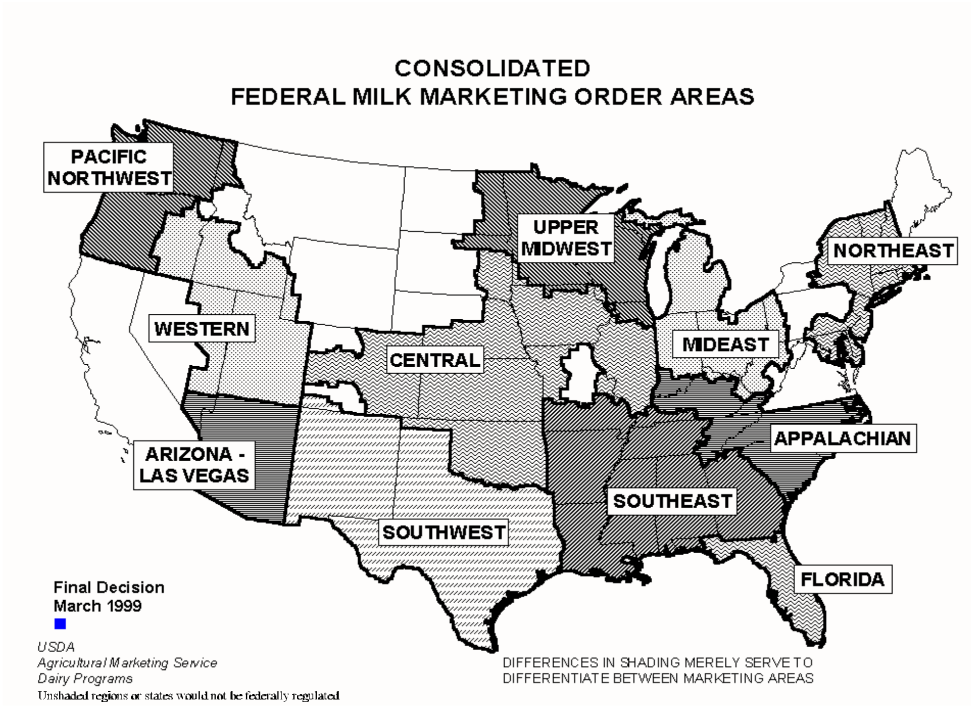
Required Consolidation of Orders. USDA's final decision reduces the number of marketing orders from 31 to 11 orders, effective January 1, 2000. In considering what regions should be combined, USDA said it looked for overlapping areas of milk supply and considered whether the proposed merged regions have other common features, such as the types of manufactured products produced. (See the maps on the following pages for a comparison of the 31 regions prior to January 1, 2000, with the new 11 consolidated regions.)

The consolidated region into which a current order is merged is important to producers in that order because of the way farm milk is priced. In general, under federal order blend pricing, the more milk that is used for fluid consumption (Class I use) in an order, the higher that order region's average farm (blend) price will be. Therefore, if Order A, for example, is consolidated with other orders that have a lower Class I utilization rate than Order A, then Order A's blend price will fall when it is consolidated. Likewise, if Order A is consolidated with regions with a higher Class I use than Order A, then farmers in Order A will have a higher blend price when consolidated.

Marketing Areas Under Federal Milk Orders as of October 1, 1997



DIFFERENCES IN SHADING MERELY SERVE TO
DIFFERENTIATE BETWEEN MARKETING AREAS



Currently, California, the largest dairy producing state, has a state milk marketing order that is separate from federal orders. The 1996 farm bill allowed California to have its own federal order if California dairy producers petitioned for and approved such an order. As amended by the FY1999 Omnibus Appropriations Act, current law gave California until October 1, 1999 to become a federal order if the state wanted to also retain its quota system. Under California's quota system, each farmer is assigned a quota for production and receives one price for production within quota and a lower price for production above quota. To date, California continues to maintain its own state marketing order and is not part of the federal order system.

Class I Differentials: Option 1A vs. Option 1B. The most controversial portion of order reform was in establishing the level of Class I differentials within each of the consolidated orders. Class I differentials are what is added to the base price of milk in a region to determine what the minimum price is processors must pay for milk used for fluid consumption. USDA's differential pricing structure is based on the “location value” of milk -- that is, calculating how far a milk consumption region is from a milk production region, and establishing a minimum price that will attract sufficient milk to the market. This system has been in operation for many years and, prior to the recent reforms, was based on the premise that the Upper Midwest is the only surplus production region in the country. Upper Midwest producer groups have long sought a revision of differentials saying that the level of differentials encourage local production in many regions of the country at the expense of milk produced in the Upper Midwest.

When USDA issued its proposed rule in 1998, it offered two options. Option 1B, USDA's preferred option, would have reduced Class I differentials in many regions, which the

Department said would make farm milk pricing more market-oriented. USDA also offered an Option 1A which would keep the Class I differentials at close to current levels. Option 1A was identified by USDA as being the most like the current pricing structure, except for some adjustments to reflect that there is more than one surplus market. Option 1B would result in lower Class I differentials for many regions, because this option recognizes that there are closer markets than in Option 1A from which milk can be drawn when supplies are low.

Many farm groups from Eastern states expressed strong disapproval of Option 1B, while producer groups in the Upper Midwest generally supported it. USDA's final decision was a modified version of the original Option 1B offered by USDA in its preliminary decision last year. For most regions, the pricing decision issued by USDA would have provided a differential that is higher than under the earlier proposed Option 1B, but still below then current differentials. However, subsequent legislation prohibited USDA from implementing this option.

Legislative Action to Mandate Option 1A. On November 29, 1999, the President signed into law the FY2000 consolidated appropriations act (P.L. 106-113, H.R. 3194) that among many provisions requires USDA to implement Option 1A as part of its final decision.[1] This provision was widely supported by dairy farmer groups in most regions outside of the Upper Midwest. Upper Midwest dairy farm groups, dairy processors, and consumer groups generally supported USDA's final decision (modified Option 1B) and strongly opposed a legislative mandate for Option 1A. Upper Midwest Senators filibustered the measure as it came to the Senate floor because of the dairy provisions. However, a cloture motion was approved (87-9) on November 19, 1999, allowing the Senate to complete action on the measure the same day. Although the Administration opposed a legislative mandate for Option 1A, the President signed the measure, since the dairy provisions were one component of a wide-ranging budget agreement between congressional leaders and the Administration on FY2000 spending and other matters. As a result, USDA was required to adopt Option 1A as part of its final decision and to implement the revised final rule, without a comment period or another farmer referendum, on January 1, 2000.) (See Table 2 for a comparison of class 1 differentials in effect prior to January 1, 2000 to USDA's "final" decision and the differentials now in effect as mandated by the legislation.)

Other dairy provisions enacted as part of H.R. 3194 include a two-year extension of the Northeast dairy compact (see "Dairy Compacts" below) and a requirement that USDA re-examine its proposed formula for pricing farm milk used for cheese and butter (see "Manufactured Dairy Product Pricing Controversy" below).

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[1]H.R. 3194 (P.L. 106-113) is a consolidation of the five appropriations bills for FY2000 that were not yet enacted as of early November, and several other authorizing measures. Regular appropriations for FY2000 agriculture spending were not part of this agreement, since a separate agriculture spending bill (P.L. 106-78) was enacted earlier. Section 1000(a)(8) of H.R. 3194 provides that upon enactment of H.R. 3194, all language in H.R. 3428 is to be considered enacted as well. H.R. 3428 contains provisions which mandate Option 1A and extend authority for the Northeast dairy compact, among other dairy provisions.

Table 2. Comparison of Pre-Reform Class I Differentials to USDA's Preferred Modified Option 1B, and Option 1A As Mandated by Legislation, Grouped by Pre-Consolidated Order Regions

Dollars per hundredweight ($ per cwt.)

Order Region	1999 Diffe-rential	Modi-fied Option 1B	Man-dated Option 1A	Order Region	1999 Diffe-rential	Mod-ified Option 1B	Man-dated Option 1A
NORTHEAST				**UPPER MIDW.**			
New England	3.24	2.75	3.25	Chicago Regional	1.40	1.95	1.80
NY-NJ.	3.14	2.50	3.15	Upper Midwest	1.20	1.60	1.70
Middle Atlantic	3.09	2.20	3.00	**CENTRAL**			
Unreg. NY & NE	2.54	2.05	2.55	Iowa	1.55	1.95	1.80
APPALACHIAN				Neb.-W. Iowa	1.75	2.00	1.85
Carolina	3.08	2.55	3.10	E. South Dakota	1.50	1.60	1.75
Tennessee Valley	2.77	2.25	2.80	Central Illinois	1.61	2.00	1.80
Louisv-Lex.-Evans.	2.11	1.95	2.20	S. Ill.-E. Missouri	1.92	2.10	2.00
SOUTHEAST	3.08	2.90	3.10	Southwest Plains	2.77	1.95	2.60
FLORIDA				E. Colorado	2.73	1.55	2.55
Upper Florida	3.58	3.80	3.70	W. Colorado	2.00	2.20	2.00
Tampa Bay	3.88	4.20	4.00	Greater Kans. City	1.92	1.90	2.00
Southeast. Fla.	4.18	4.29	4.30	**SOUTHWEST**			
MIDEAST				Texas	3.16	2.10	3.00
Michig-Up. Penin	1.35	1.50	1.80	New Mex-W. Tex.	2.35	1.75	2.25
S. Michigan	1.85	1.85	1.80	**WESTERN**			
E. Ohio-W. PA	2.00	2.00	2.00	SW Idaho-E. Oreg	1.50	1.35	1.60
Ohio Valley	2.04	2.00	2.00	Great Basin	1.90	1.50	1.90
Indiana	1.90	2.00	2.00	**ARIZ-LAS VEG.**	2.52	1.55	2.35
				PACIFIC NW	1.90	1.45	1.90

Source: U.S. Department of Agriculture. *Federal Milk Marketing Order Reform. Regulatory Impact Analysis*, March 1999.

Forward Price Contract Pilot Program. Another provision in the enacted legislation authorizes a temporary pilot program to allow individual dairy farmers or their cooperatives to enter into forward price contracts with processors for certain uses of milk. A forward price contract allows buyers and sellers of a commodity to negotiate a price for the commodity on a future delivery date and insulates both parties from price volatility. Under current law, a processor must pay a producer no less than the blend price (a weighted-average market price) each month for any milk the processor purchases. Some say that this discourages the use of forward price contracts for milk that is covered by federal orders. The adopted pilot program will allow producers and cooperatives to enter into forward price contracts for all milk used for manufactured products. The contracted price will be the relevant price that the processor must pay, regardless of what the blend price is at the time of delivery. Some farm groups are concerned that forward pricing might harm the effectiveness of the federal order system, if large quantities of milk are priced outside of the mandated minimum pricing requirements of orders. Other farm groups view forward pricing as a desirable risk management tool. By law, the forward pricing program must terminate on December 31, 2004.

USDA issued final regulations for the forward price contract pilot program on July 18, 2000, which makes the program operational from August 1, 2000, through December 31, 2004. The final rule removed a controversial provision from the preliminary rule that would have given dairy farmers up to 3 days after signing a forward contract to decide whether to void the contract. Dairy processors sought for the deletion of this provision, contending that the three-day waiting period was excessive and that it would have required processors to absorb any price risk during that period. Some dairy farmer groups countered that the three-day period was a reasonable period of time. Another controversial provision that was removed in the final rule was a proposed 6-month limit to the term of any forward contract. The National Milk Producers Federation, the largest trade group representing dairy farmer cooperatives, supported the 6-month provision, but some producer and processor groups contended that the contract term should be longer.

Replacing the Basic Formula Price (BFP). USDA's final decision also includes a replacement for the current basic formula price (BFP), which has served as the base price for all milk prices under the federal order system. The BFP is based on market prices paid by processors for unregulated Grade B milk in the Upper Midwest (U-M), updated by monthly changes in prices for manufactured dairy products, particularly cheese. The BFP has served as the Class III price, or the minimum price for all farm milk used for storable manufactured dairy products (butter, cheese, and nonfat dry milk), and the base price for milk used in Class II (other manufactured) products and Class I (fluid) milk. Since the amount of Grade B production has dwindled significantly over the years, USDA sought an alternative pricing measure that reflects changes in market supply and demand.

USDA's final rule contains a four-class pricing plan that establishes a Class III price for cheese and a separate Class IV price for milk used for butter and powdered milk. Each of these two class prices are now to be computed based on the value of the components going into the production of these products. For example, the Class III cheese price is to be based on the value of protein, butterfat and lactose, the principal components of cheese. This method recognizes that the butter/powder market and the cheese market are two distinct markets and therefore should be priced separately.

Under the order system prior to implementation of the final rule, the minimum price paid by processors for milk used for fluid consumption (Class I) each month was equal to the basic formula price plus the regional Class I differential. The final decision continues the method of adding the Class I differential to a base price. However, the base price under the new system is now based on the higher of the Class III (milk used for cheese) or Class IV (milk used for butter/powder) price in each month. Under the old pricing system, the direction of farm milk prices was heavily dependent on the direction of prices in the cheese market. The newly implemented method of using the higher of the Class III or Class IV price will mean that if butter/powder prices are strong while cheese prices are weak, farm milk prices will not be as adversely affected as they are under the old system.

Manufactured Dairy Product Pricing Controversy. Another source of controversy in USDA's final decision surrounds the new method by which USDA computes the Class III price, that is, the minimum farm price of milk used for cheese. In determining the Class III price, the final rule requires USDA to use a monthly survey of the wholesale price of cheese and determine the farm value of the milk that went into the manufacturing of the cheese. Before determining the farm value, the formula subtracts from the wholesale price of cheese a so-called "make allowance," which represents the cost to processors for converting the milk into cheese. There is an inverse relationship between the cheese make allowance and the Class III price; that is, the higher the make allowance is set, the lower the minimum Class III price paid to farmers will be. Many farm groups contend that USDA's final decision has set the make allowance for cheese too high, thus meaning lower minimum prices paid to farmers for milk used for cheese. Since the higher of the Class III or Class IV price is also used as the base price for Class I milk, it might also mean lower prices for Class I milk as well, farm groups contend.

A provision in H.R. 3428, enacted as part of the FY2000 consolidated appropriations act (P.L. 106-113, H.R. 3194) requires USDA to re-evaluate its make allowance for both cheese (Class III) and for butter and nonfat dry milk (Class IV), and use formal rulemaking to develop its pricing policy. In the meantime, the law allows USDA to maintain the cheese make allowance at the final decision level of 17.02 cents per lb. (An earlier bill (H.R. 1402) passed by the House on September 22, would have required USDA to use a cheese make allowance of 14.7 cents per lb. in the interim, but this provision was dropped in the enacted version of H.R. 3194.) P.L. 106-113 requires USDA to publish a final decision on the Class III and Class IV milk pricing formulas on December 1, 2000, and implement the decision on January 1, 2001. USDA has accepted industry proposals for modifying the Class III and IV pricing methods and held a hearing to gather additional public comments on May 8, 2000.

Dairy Compacts

Background

The 1996 farm bill gave the Secretary of Agriculture the power to grant the New England states the authority to enter into a regional dairy compact. Under the authorizing statute, this authority ends at the same time as the adoption of the required consolidation of federal milk marketing orders, which was set in current law as October 1, 1999. The legislatures of the six New England states agreed to enter into a dairy compact that would create an interstate commission with the power to set a minimum price paid by dairy processors to dairy farmers in the six New England states at a level above the federal minimum price. However, any proposed interstate compact had to be approved by Congress, as required by the interstate commerce clause of the U.S. Constitution.

New England farm groups support the compact because they believe that the current minimum milk prices dictated by federal milk marketing orders are not sufficient to cover the cost of producing milk on family-sized farms, thus forcing many dairy farmers out of business. The strongest opponent of the Northeast compact has been Upper Midwest dairy producer groups which maintain that the compact artificially encourages the production of milk within the compact region at the expense of other parts of the country that have lower production costs and can sell at lower prices. In addition, opponents maintain that the compact could set a precedent for other regions and industries to protect themselves from competition, an action which critics maintain is anti-consumer and market-distorting.

In late May 1997, New England dairy farmers gave nearly unanimous approval to a compact commission-proposed minimum price of $16.94 per cwt. for Class I milk in the compact region. (This compares with an average minimum fluid milk price of $14.82 for the first 8 months of 1997 in the New England milk marketing order; a 1996 average of $16.88; and a 1995 average of $14.87.) The $16.94 floor price became effective on July 1, 1997 and currently serves as the floor price for farm milk used for fluid consumption in the Northeast compact region.

Following the creation of the Northeast compact, many other states expressed interest in either joining the Northeast compact or forming a new, separate compact in the South. Current law allows New York, Pennsylvania, New Jersey, Delaware, and Maryland to join the Northeast compact as long as their membership is approved by their respective state legislatures and by the Congress. All five state legislatures have approved membership; congressional approval is pending. Fourteen other states, mainly in the South, have approved membership of their states in a new Southern dairy compact, which is also awaiting congressional approval.

Current Compact Issues

Extending the Sunset Date. The 1996 farm bill (P.L. 104-127) required the Northeast dairy compact to terminate upon implementation of federal milk marketing order reforms. P.L. 104-127 mandated an April 4, 1999 deadline date for these reforms. However, a provision in the Omnibus Consolidated and Emergency Appropriations Act, 1999 (P.L. 105-277) extended the deadline date for reform to October 1, 1999, which in effect extended the life of the dairy compact until that date. On September 28, 1999, a federal judge granted a temporary restraining order requested by Northeast dairy farm groups to prohibit USDA from implementing its final rule for federal milk marketing order pricing reform on October 1. Since the termination of the dairy compact is directly tied to the implementation date of order reform, the compact did not terminate on October 1.

A provision in the dairy legislation (H.R. 3428) that was enacted as part of the FY2000 consolidated appropriations act (P.L. 106-113, H.R. 3194) extends authority for the Northeast dairy compact by 2 years until September 30, 2001. The measure does not address the extension of membership in the compact to the five states (NY, NJ, PA, DE and MD), which have approved membership in the compact at the state legislature level. Congressional approval is required before these states can join the Northeast compact.

Northeast Compact Supply Management Program. The Northeast Dairy Compact Commission has issued proposed regulations for a supply management program that the Commission says will help prevent potential overproduction of milk in the Northeast region. Critics of the dairy compact contend that the higher mandated farm milk prices under the compact encourage farmers in the region to overproduce milk, which they say depresses milk prices for dairy farmers in other regions. The proposed rule would provide for an assessment of 5 cents per hundredweight (cwt.) on all farm milk sold within the compact region. At the end of the year, the annual funds collected would be refunded to any compact eligible producer who increased his annual milk production by less than 1%. One-half of the total amount refunded would be divided equally among all eligible compact producers; the other half would be distributed based on the total volume of milk produced during the year. A hearing on the proposed rule was held on April 5, 2000. In May, farmer members of the compact voted to approve the rule. The rule has been finalized and was printed in the *Federal Register* on July 7, 2000. Supporters of the assessment say that it will control potential excess production of milk in the Northeast and help limit the purchase of surplus dairy products by USDA. Opponents contend that the supply management program will be ineffective, and that it is designed more to fend off criticism of the compact as its sunset date approaches later next year.

Massachusetts State Legislature Action on Rescinding Compact Membership. The Massachusetts State Senate voted in late May 2000 as part of the state's annual budget plan to withdraw Massachusetts from the Northeast dairy compact and instead allocate $3 million annually for a trust fund to benefit state dairy farmers. However, the withdrawal provision was deleted from the state budget in conference committee. Supporters of the provision to remove Massachusetts from the compact contended that consumers in the state are contributing significantly more to the compact than the benefits accruing to Massachusetts dairy farmers. Major Northeast dairy farmer groups spoke out in opposition to the rescinding provision. If Massachusetts were to leave the compact, it could potentially threaten the membership of Connecticut and Rhode Island, since current law requires a member state to be contiguous to another member state.

Proposed Southern Dairy Compact. H.R. 1604 and S.J. Res. 22, as introduced in late April 1999, would grant congressional approval for a new Southern dairy compact. The following states already have enacted legislation approving membership in a Southern dairy compact: Alabama, Arkansas, Georgia, Kansas, Kentucky, Louisiana, Mississippi, Missouri, North Carolina, Oklahoma, South Carolina, Tennessee, Virginia, and West Virginia. Other states likely to consider membership are Texas and Florida. Congressional approval for the Southern compact was considered during conference deliberations on the FY2000 agriculture appropriations bill. A threatened filibuster by Upper Midwest legislators forestalled this action. Authority for a Southern compact also was not included in the subsequent dairy legislation (H.R. 3428) adopted by Congress that extended the authority of the Northeast compact for 2 years.

For more background on the Northeast dairy compact, see CRS Report 96-814, *The Northeast Interstate Dairy Compact*.

LEGISLATION

P.L. 106-78/H.R. 1906 (Skeen)

The FY2000 Appropriations Act for the U.S. Department of Agriculture and Related Agencies. Among emergency provisions in the measure: 1) Section 805 authorizes the Secretary to provide $125 million to compensate dairy producers for economic losses incurred during 1999, and, 2) Section 807 extends authority for the dairy price support program for one additional year, through December 31, 2000. Conference agreement approved by the House on October 1, 1999 and the Senate on October 13, 1999. Signed into law on October 22, 1999.

P.L. 106-113, H.R. 3194 (Istook)/H.R. 3428 (Blunt)

Like H.R. 1402, H.R. 3428 requires the Secretary to adopt Option 1A as the pricing structure for fluid-use milk under federal milk marketing orders and provides temporary authority for forward price contracting between dairy producers and processors. The bill also provides a two-year extension of authority for the Northeast dairy compact until September 30, 2001 and requires USDA to reconsider its method for determining the cheese and butter/powder make allowance, but maintains the make allowances at the proposed levels in the interim. H.R. 3428 was introduced November 17, 1999; referred to the Committee on Agriculture, and subsequently included in a consolidated budget package (H.R. 3194) approved by Congress.

Section 1000(a)(8) of H.R. 3194 (a comprehensive FY2000 appropriations bill) provides for the enactment of H.R. 3428 upon enactment of H.R. 3194. The conference agreement to H.R. 3194 was approved by the House on November 18, 1999 and the Senate on November 19, 1999. Signed by the President on November 29, 1999.

H.R. 4461 (Skeen), and Senate Amendment to H.R. 4461 (Cochran)

The House and Senate versions of bills which make appropriations for agriculture, rural development and related agencies for FY2001. The Senate-passed version of H.R. 4461 provides supplemental spending of $443 million in income assistance payments to dairy farmers. No comparable provisions are in the House bill. The House-passed and Senate-reported versions of H.R. 4461 also contain a one-year extension of authority for the dairy price support program. (Due to a technical error, the provision for extension of the price support program was inadvertently deleted in the printed version of the Senate-passed bill. H.R. 4461 reported to the House (H.Rept. 106-619) on May 16, 2000. Passed the House by a vote of 339-82 on July 11, 2000. S. 2536 reported to the Senate (S.Rept. 106-288) on May 10, 2000. Text of S. 2536, as amended, substituted for the text of H.R. 4461, and passed by the Senate on July 20, 2000 by a vote of 79-13.