STATEMENT OF RONALD D. KNUTSON
DIRECTOR, AGRICULTURAL AND FOOD POLICY CENTER
TEXAS A&M UNIVERSITY
ON DAIRY POLICY REFORM
BEFORE THE LIVESTOCK, DAIRY AND POULTRY SUBCOMMITTEE
COMMITTEE ON AGRICULTURE
U.S. HOUSE OF REPRESENTATIVES

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Since the 1996 Farm Bill was enacted, Agricultural and Food Policy Center (AFPC) faculty have been analyzing the impacts of milk marketing order reform proposals. As the Director of the Center, I have been directly involved in these analyses. Our role is one of analyzing the economic consequences of reform options. Our business is to neither advocate policy change nor to make recommendations.

Our analyses have concentrated on two primary areas:

(1) We have evaluated alternatives to the Basic Formula Price (BFP) for pricing manufactured products and for moving the Class I price.

(2) We have evaluated the farm level impacts of the proposed rule.

Basic Formula Price

Our evaluations of the proposed rule provisions for pricing milk used for manufacturing and the BFP have led to the following conclusions:

(1) Pricing Class III milk used for cheese on the basis of butterfat and protein components represents a significant economic improvement over the current BFP in reflecting supply-demand conditions for milk and in reflecting product prices.

(2) The establishment of a butter-powder formula for pricing Class IV products holds the potential for these products being more competitive in international markets.

(3) The Class I price mover, being a moving average of the Class III and Class IV price, is more stable than the current BFP.

(4) A significant problem presented by the Class III and Class IV proposals is that they lead to higher prices than exist for comparable use Classes in California. Unless these differences are resolved, competitive distortions which have characterized the milk industry for at least the past decade will continue to evolve as a destabilizing force in the dairy industry. Options for remedying these

differences include some combination of raising the Federal Order make allowance, using western manufactured product prices and/or eliminating whey from the cheese formula. NASS-surveyed cheese prices have been below prices generated by the Chicago Mercantile Exchange (CME). Survey prices are to be used in calculation of the Class III and Class IV prices. But, because no survey prices on butter and powder have been done historically, readily available spot market prices were used in USDA's reform analysis. Survey prices may be expected to generate Class prices below those in the reform analysis package. Our analysis suggests that the use of a NASS survey price for block and barrel cheese, combined with the make allowance generated from a survey completed by the Rural Cooperative Business Service unit of USDA, would generate a Class III price that is within $0.10 per cwt. of the comparable California price.

Farm Level Impacts

Our evaluations of the farm level impacts of the proposed rule have led to the following conclusions:

(1) The economic basis for the 1B phase-in option is sound but substantial regional adjustment should be anticipated from its adoption.

(2) Farms located in proximity to the new 1B basing points having substantial Class I utilization would incur substantial reductions in net cash income with increased probabilities of experiencing cash flow deficits and sometimes requiring refinancing. An analysis of the 1B options for Class I pricing on AFPC's representative dairies reveals these points (see attached figures). The 1B phase-in options result in declines in net cash farm income (NCFI) ranging between 41 percent and 53 percent for a moderate size 400-cow Central Texas dairy. The large Central Texas dairy experiences declines in NCFI between 13 and 17 percent. Perhaps more important, the probability of cash flow deficits for this large farm almost double to a 19 percent chance, on average. The probability of a cash flow deficit means that due to price, yield and production variability, the farm will not have enough money to cover cash expenses in 19 out of 100 years. By 2004, the probability of a cash flow deficit exceeds 25 percent for each 1B

option. The moderate-size Central New York dairy (110 cows) also experiences reduced net cash farm income and the probability of a cash flow deficit increases to 90 percent by 2004.

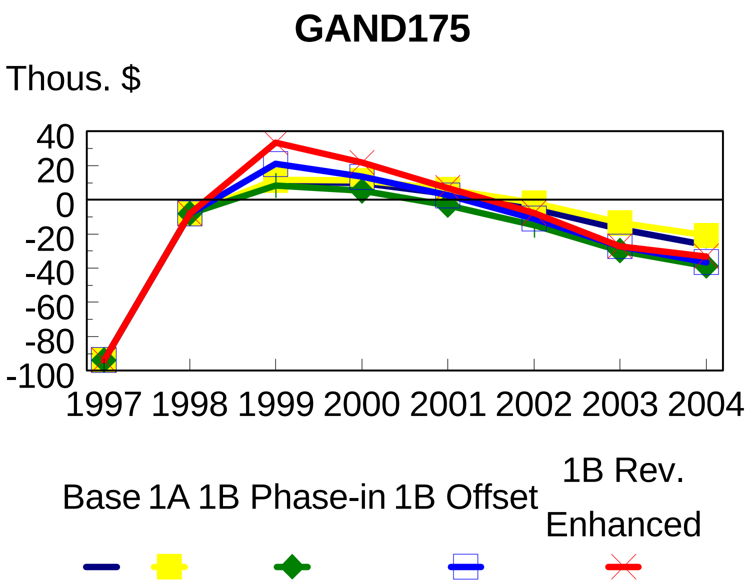
(3) Farms that gain from employment of the 1B options tend to be located in areas where most of the milk is processed into manufactured products. The representative farms in Wisconsin and Idaho experience higher net cash farm incomes under the 1B options in the range of 3 to 8 percent. These areas have low Class I utilization and benefit from higher prices for milk and in manufactured products.

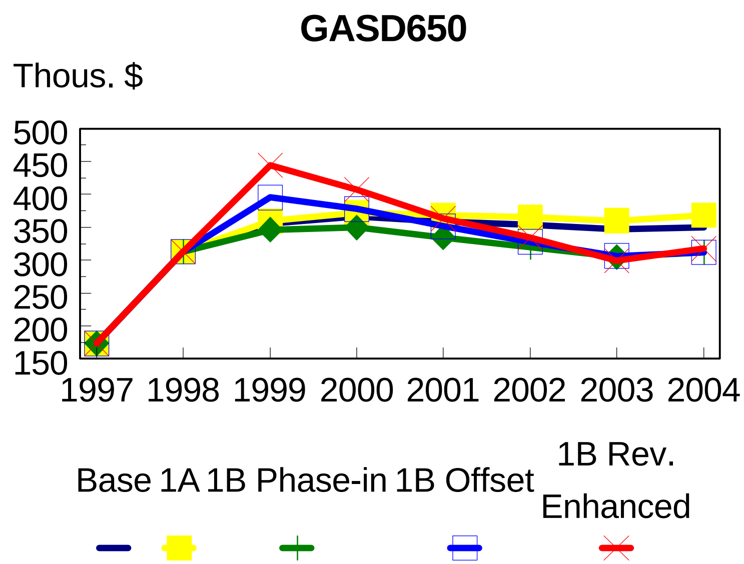
(4) Producer dissatisfaction with the proposed rule creates the potential for an even more fragmented dairy industry composed of a series of regional dairy compacts.

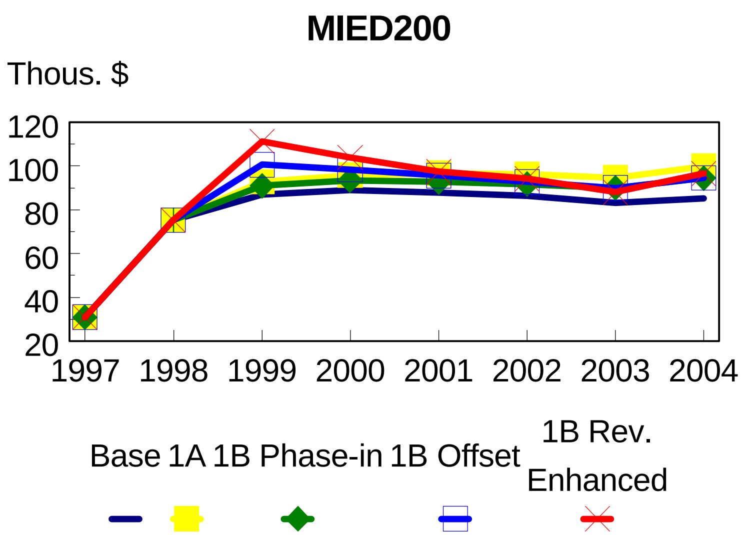
Conclusion

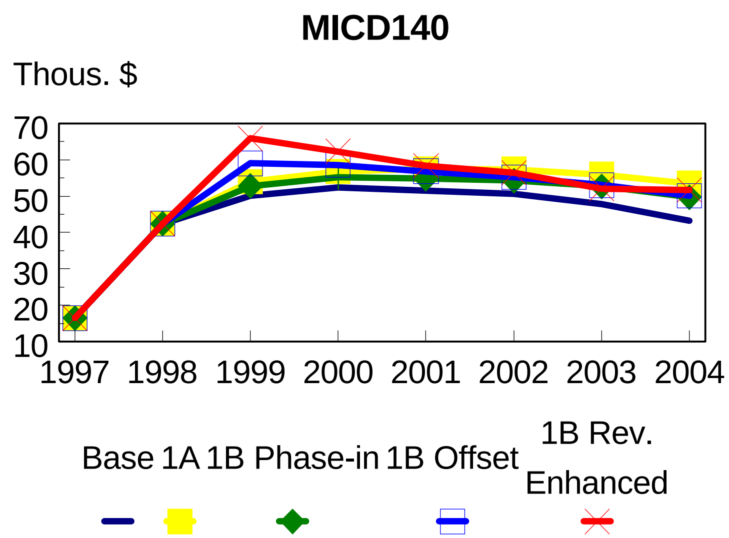
From an economic perspective, it is important that the industry and USDA come to closure on a proposed rule with which all interested parties can live. Increasing regionalization of the milk industry is a disturbing and divisive phenomena that runs counter to the inevitable development of national and global markets for U.S. dairy products.

Representative Dairy Farm NCFI Under the FMMO Reform Proposed Rule Options









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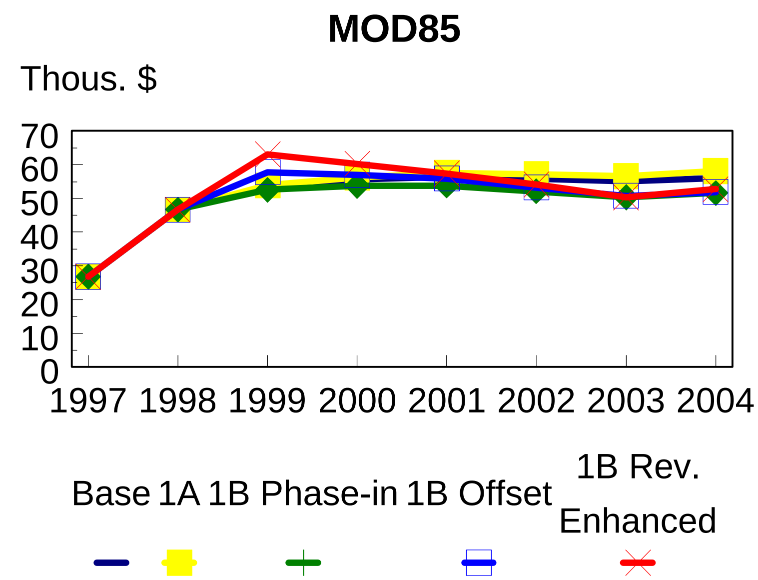

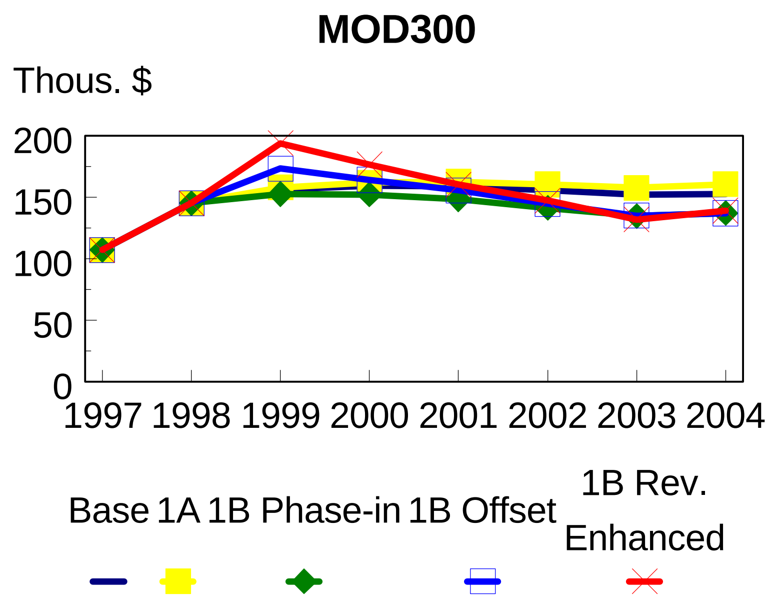

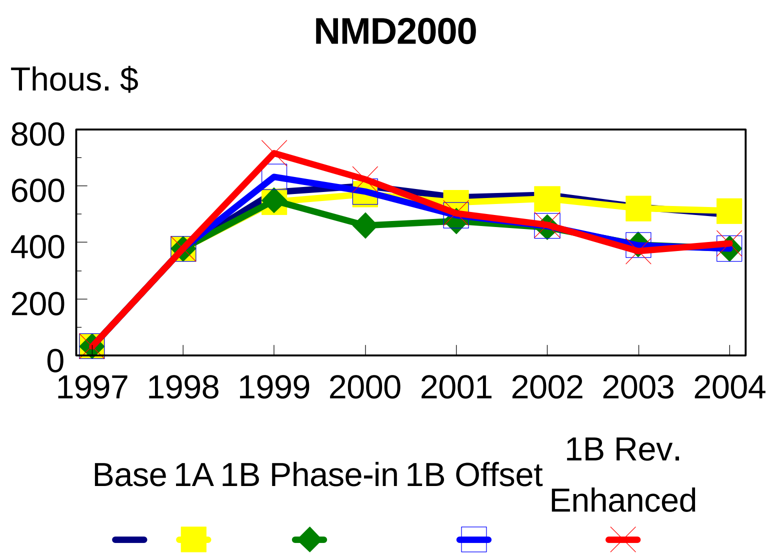

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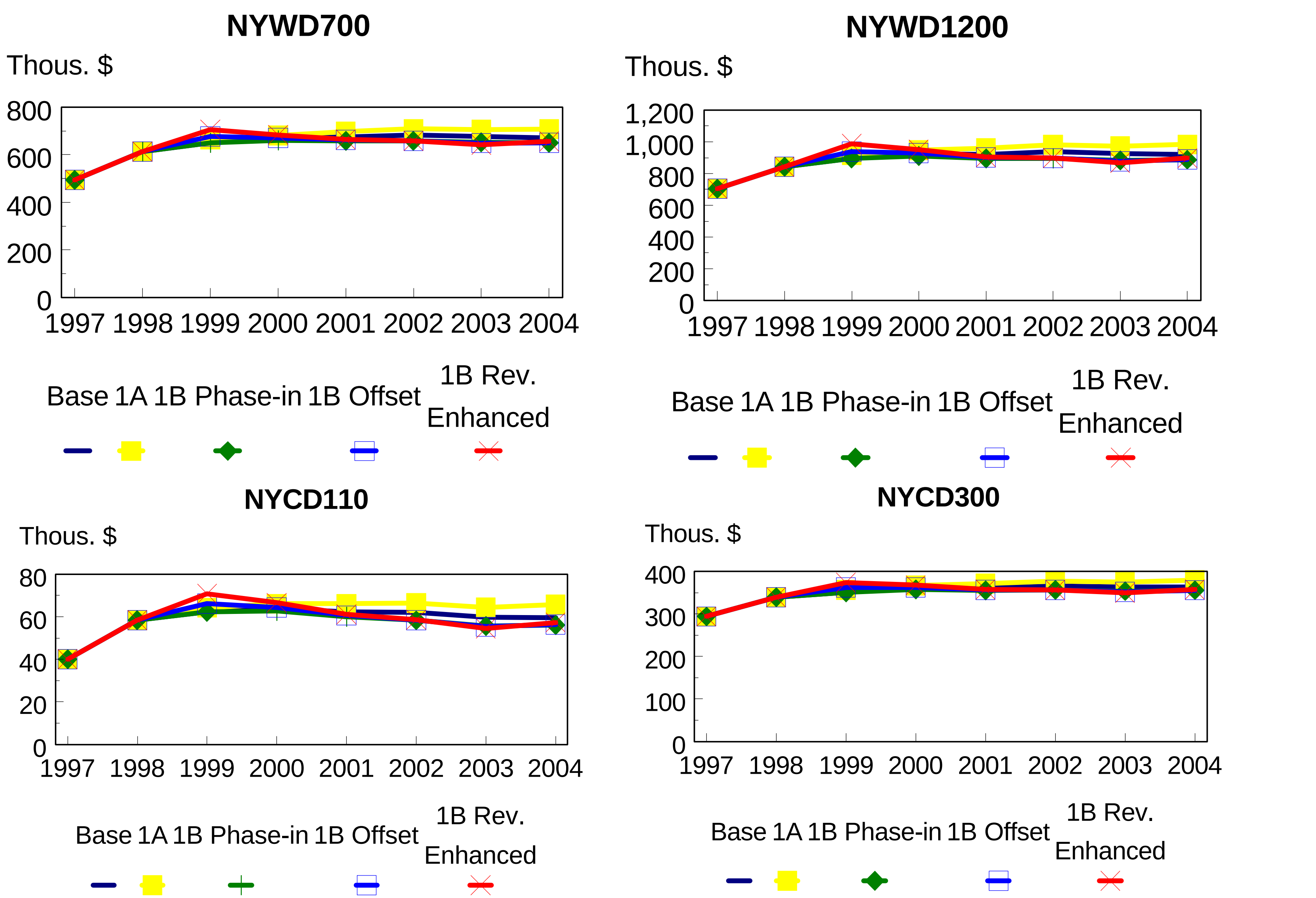

Representative Dairy Farm NCFI Under the FMMO Reform Proposed Rule Options

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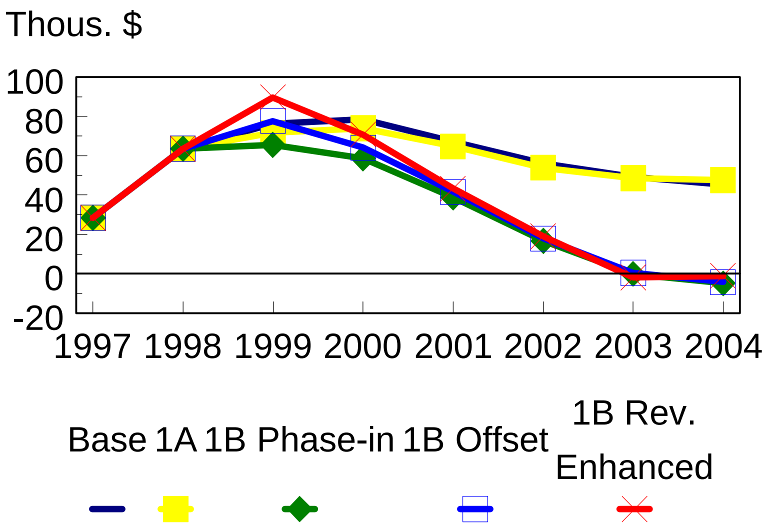

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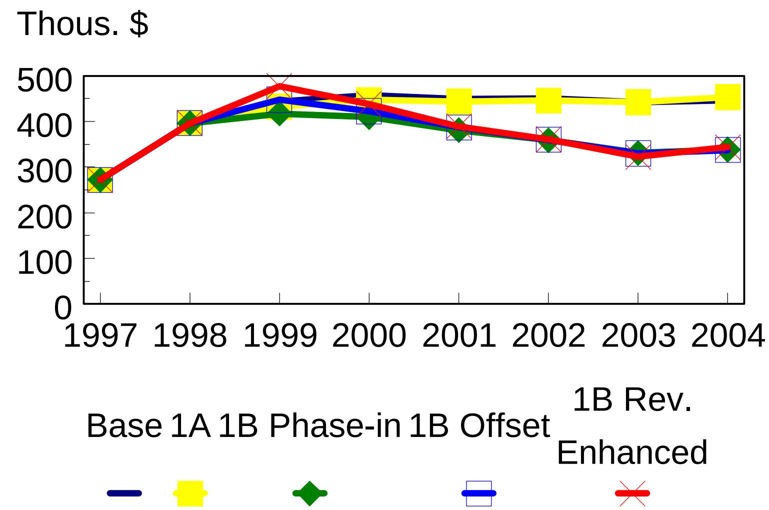

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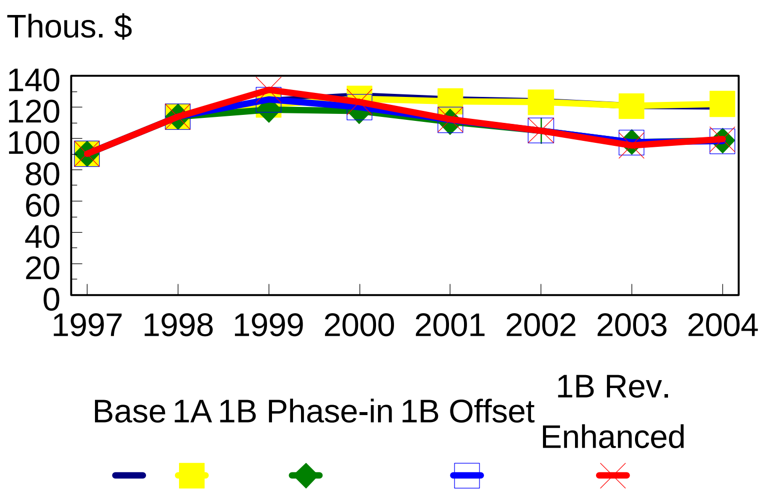

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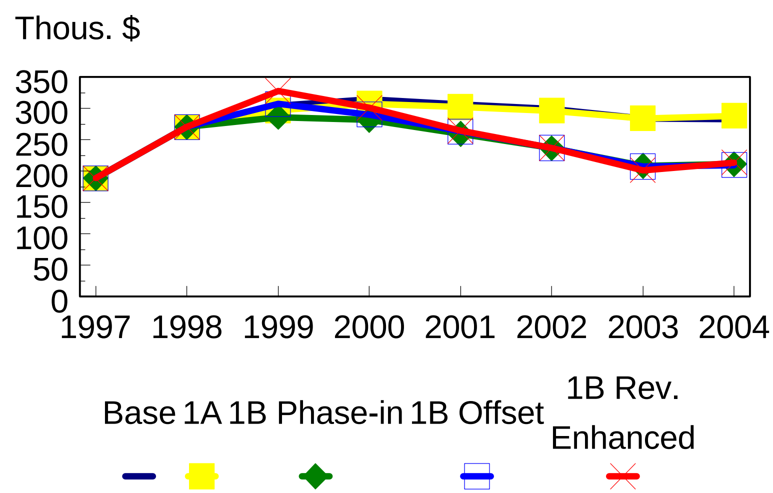

Representative Dairy Farm CFI Under the FMMO Reform Proposed Rule Options