Has the time come for federal order reform 2.0?

by Mike McCully

THE dairy market disruptions from COVID-19 through 2020 and into 2021 exposed flaws in the foundation of U.S. dairy policy and milk pricing. Numerous discussions have been had over negative producer price differentials (PPDs), depooling, the Class I formula, and other aspects of the arcane Federal Milk Marketing Order (FMMO) system. While many dairy farmers, and others throughout the industry, have not fully understood milk pricing, they have now lost some trust in the system with few believing it is working for them. A Senate hearing in September concluded with everyone saying the system needs to change, but there was no consensus on how to move forward.

A recent announcement of legislation directing USDA to hold hearings to "fix" things is a start, but more work is needed to develop a framework to modernize milk pricing in the U.S. Perhaps the federal order reform process from the 1996 Farm Bill could be used as a model to bring industry, academics, and others together to work on the key aspects of dairy policy.

Can you see the rocks?

First, the debate around the Class I formula, depooling, and negative PPDs is like rocks in a pond. When the water went down in 2020, we saw the rocks, but they didn't just show up — they were always there.

The fundamental problem is that the FMMO system is based on Class I milk and the revenue generated from Class I sales, which is viewed as the highest value use of milk in the FMMO system. However, as fluid milk consumption has dropped sharply over the last decade, there are simply not enough sales to generate the revenue needed to make the orders work as designed in the 1930s or even the late 1990s.

In the mid-1990s, when federal order reform started, roughly one-third of the milk in the U.S. was used in fluid milk beverages. That number has dropped to under 20% in some months in 2021.

More importantly, the amount of milk exported has gone from around 3% in the mid-1990s to near 20% in recent months. In other words, the U.S. is exporting more product than goes into fluid milk. That is a seismic shift in utilization and one the current FMMO system was not designed for. With exports being key to future U.S. dairy industry growth, dairy policy needs to adapt to this new reality.

Competitors to the U.S. in the global dairy market do not have to deal with the limitations from federal order milk pricing, standards of identity, and other regulations unique to the U.S. This can put U.S. dairy companies at a disadvantage.

New Zealand, Australia, and Europe operate in free market systems for dairy, which has allowed companies in those countries to innovate and develop value-added products. From 2017 to 2019, the average value of European and New Zealand dairy exports was 40% to 60% higher than the U.S. Consider the additional value in the market that U.S. dairy farmers and processors could capture through investments in processing technology and product innovation.

Unfortunately, the U.S. milk pricing system is based on commodity products, which results in commodity (low) milk prices. Furthermore, the FMMO system incentivizes the production of commodity products through product price formulas. The result is a minimum price that is then used as the benchmark price for all milk. Moving to a free-market system where plants innovate, compete for milk, and create more value for dairy products benefits everyone along the dairy value chain from farmers to dairy processors to consumers. This should be the ultimate goal of future dairy policy.

The future

There are a number of impediments to change, including fear of the unknown. Companies and people are invested in the current system, and some have figured out how to make it work for them. Unfortunately, dire predictions are made of what could happen if pricing regulations were relaxed or removed.

But we don't have to speculate what the future could hold. Look at the success Idaho has had since deregulating in 2004. The state is now the No. 3 milk producer in the U.S. and has seen billions of dollars in investment in new plants. Milk pricing is easy to understand and dairy farmers are able to effectively manage their margin risk from volatile milk prices, another goal of future dairy policy.

The activity around changes to U.S. dairy policy has quieted down in recent months, but this is a mistake. The old saying is to fix your roof while the sun is shining. Unfortunately, the history with dairy policy has been a call to change when milk prices are low, but then everything is fine when prices are high.

I have my opinions on what needs to change, first by making milk pricing simple and easy for everyone to understand. Policies should foster innovation and investment in new products and allow milk to move to the highest value use through competition, not rigid government formulas.

And let's not limit the discussion to just the federal order system. We also need to factor in how new environmental programs will impact dairy, what changes — if any —should be made to existing dairy farm safety nets, and if dairy can participate in the massive investments being made in infrastructure. Finally, let's not judge the effectiveness of any new policies on what it does to next month's milk price. Dairy policy needs to be designed for the markets and industry of the next decade, not the last decade.

Regional interests

The politics of dairy are a rare example of bipartisan alliances, but they are marred by regional fights. These have not been helpful in the past and should be avoided as much as possible. The "what" in changes to dairy policy are easier than the "how" in getting them implemented.

Let's start by defining guiding principles on what a future dairy policy framework looks like and developing a timeline for implementation. This should be viewed as a glide path over time and not an abrupt change from one month to the next.

The FMMO system brings a lot of value and could perform new functions like expanded weekly price reporting of milk, component, and product prices. This would bring information to all participants needed to negotiate pricing contracts.

New futures contracts could be developed for butterfat and protein prices in addition to one milk price. A basis market would quickly develop to determine location values for milk and products. In short, there are enough smart people to figure out how dairy pricing works without a government regulated system doing it for them.

The dairy industry has a unique opportunity over the next several years to rethink and redesign federal dairy policy. My fear is inertia, one of the strongest forces in the universe, will lead to no or only incremental changes to a system that is fundamentally broken. Removing outdated regulations could let the dairy industry prosper, bringing more money and profits to dairy farmers and processors. Get involved in various industry groups to make your voice heard and help lead successful change.

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