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Dairy Policy and the 2007 Farm Bill

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Summary

Two federal programs that support the price and income received by dairy farmers are expiring in 2007 — the dairy price support program and the Milk Income Loss Contract (MILC) program. The reauthorization of these and other farm commodity price and income support programs is being debated by the 110th Congress in the context of an omnibus 2007 farm bill. On July 27, 2007, the House completed action on its version of the 2007 farm bill (H.R. 2419), which reauthorizes both dairy programs and addresses other dairy issues. Senate committee action on the 2007 farm bill is expected in September.

The MILC program allows participating dairy farmers to receive a government payment when the farm price of milk used for fluid consumption falls below an established target price. H.R. 2419 extends the program through FY2012, at the current level of support. The MILC program is generally supported by milk producer groups in the Northeast and the Upper Midwest. Large farmers, particularly in the West, contend that the program payment limit is biased against them. Program payments were scheduled to expire one month before the end of FY2007 (August 31, 2007), meaning that no funding would be available for the program in the next farm bill. However, a provision in the FY2007 Iraq war supplemental act (P.L. 110-28) funds the MILC program through the end of FY2007, thus creating a budget baseline for the program beyond its expiration date.

The dairy price support program indirectly supports the farm price of milk at $9.90 per hundredweight (cwt.) until December 31, 2007, through government purchases of surplus dairy products from dairy processors. Most dairy farm groups and the Administration view the program as a necessary safety net in a market that is frequently characterized by volatile prices. Dairy processors consider the price support and MILC programs to operate at cross-purposes, which they say contributes to surplus milk production. Others are concerned that dairy support might have to be modified in order to comply with U.S. trade obligations in the World Trade Organization. H.R. 2419 extends the dairy support program for five years (through 2012), but modifies the program so that it directly supports the prices of dairy products at mandated levels rather than indirectly supporting the price of farm milk.

A third federal dairy pricing policy tool, federal milk marketing orders, requires dairy processors in many regions to pay a minimum price for farm milk depending on its end use. Federal orders are permanently authorized and most changes are made administratively by USDA through the rulemaking process. However, a number of federal order issues have been brought to the attention of Congress for the farm bill debate. Dairy processors are seeking a change in statute that would exempt them from paying the federal minimum price whenever they forward contract prices with dairy farmers, a provision adopted on a temporary basis by H.R. 2419. Separately, H.R. 2419 contains a provision that allows USDA to implement a 2002 farm bill-mandated assessment on imported dairy products, which is supported by most milk producer groups, but opposed by dairy importers and processors.

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Overview

The Farm Security and Rural Investment Act of 2002 (P.L. 107-171, the 2002 farm bill) is the most recent omnibus farm bill, covering a wide range of programs including commodity price and income support, farm credit, agricultural conservation, research, rural development, and foreign and domestic food programs, among others. Many of the provisions of the existing farm bill expire in 2007, and Congress is currently considering options for renewal.

Subtitle E of the commodity programs title (Title I) of the 2002 farm bill contains the authority for two major dairy policy tools currently used by the U.S. Department of Agriculture (USDA) to support the prices and incomes received by dairy farmers — the dairy price support program and the Milk Income Loss Contract (MILC) program. The MILC program is scheduled to expire on September 30, 2007, and the dairy price support program on December 31, 2007. At issue for the 110th Congress is whether to reauthorize these two programs in their current forms or with modifications to make the programs more compatible with U.S. trade obligations in the World Trade Organization, and to address other issues of concern. On July 27, 2007, the House completed action on its version of the 2007 farm bill (H.R. 2419), which included reauthorization of these two dairy programs.

A third federal dairy policy tool, federal milk marketing orders, requires dairy processors to pay a minimum price for farm milk depending on its end use. Federal orders are permanently authorized and changes are generally made administratively by USDA. However, issues such as the proposed authority for processors to be exempt from federal order minimum prices processors when they forward contract with dairy farmers, is being brought to the attention of Congress. H.R. 2419, as passed by the House, authorizes a temporary forward contract program (through September 30, 2012) and contains safeguards designed to ensure that dairy farmers are not compelled by processors to participate in the program. H.R. 2419 also would authorize a commission to review and evaluate federal milk marketing order policies and procedures and require the commission to report its findings within two years of its first meeting.

Milk Income Loss Contract (MILC) Program

Background

In FY1999-FY2001, Congress provided just over $32.5 billion in emergency spending for U.S. Department of Agriculture (USDA) programs, primarily to help farmers recover from low farm commodity prices and natural disasters. The majority of these funds were for supplemental direct farm payments made to producers of certain commodities, primarily grains and cotton, but also including soybeans, peanuts, tobacco, and milk. Of this amount, dairy farmers received supplemental "market loss" payments of $200 million in FY1999 under the Omnibus Consolidated and Emergency Supplemental Appropriations Act, 1999 (P.L. 105-277), $125 million under the FY2000 agriculture appropriations act (P.L. 106-78), and $675 million under the emergency provisions in the FY2001 agriculture appropriations act (P.L. 106-387).

Some dairy farmer groups sought a permanent direct payment program for dairy farmers to be included in the 2002 farm bill as a means of supplementing dairy farm income when farm milk prices are low. Prior to the emergency payments made each year on an ad-hoc basis in FY1999 through FY2001, dairy farmers generally were not recipients of direct government payments. However, some groups contended that farm milk prices had been volatile in recent years and that dairy farmers needed more income stability.

Separately, the Northeast Dairy Compact, which provided price premiums to New England dairy farmers when market prices fell below a certain level, expired on September 30, 2001. These premiums were funded by assessments on fluid milk processors, whenever fluid farm milk prices in the region fell below $16.94 per hundredweight (cwt.). Supporters of the Northeast Compact had sought for an extension of the compact; the southeastern states were seeking new authority to create a separate compact. However, dairy processors and Upper Midwest producers strongly oppose regional compacts.

In response, Section 1502 of the Farm Security and Rural Investment Act of 2002 (P.L. 107-171, the 2002 farm bill) authorized a new counter-cyclical national dairy market loss payment program. (Upon implementation, USDA dubbed the program the Milk Income Loss Contract (MILC) program.) This program did not replace the dairy price support program or federal milk marketing orders, other current federal milk pricing policy tools. Instead, it was created as an alternative to regional dairy compacts and ad-hoc emergency payments to farmers, by authorizing additional federal payments when farm milk prices fall below an established target price. Authority for the MILC program expired on September 30, 2005, as required by the 2002 farm bill. However, the Deficit Reduction Act of 2005 (P.L. 109-171) authorized funding for the program until August 31, 2007. Subsequently, the FY2007 Iraq war supplemental act (P.L. 110-28) extended funding for the program by an additional month through September 30, 2007. (See "MILC and the Baseline Budget," below, for details on the budget implications of these funding extensions.)

MILC Program Mechanics

Under the MILC program, dairy farmers nationwide are eligible for a federal payment whenever the minimum monthly market price for farm milk used for fluid consumption (Class I) in Boston falls below $16.94 per hundredweight (cwt.).[1] In order to receive a payment, a dairy farmer must enter into a contract with USDA. Under the original farm bill authority, a producer received a payment equal to 45%

[1] A hundredweight (or one hundred pounds) of milk is roughly equivalent to 11.6 gallons of milk.

of the difference between the $16.94 per cwt. target price and the market price, in any month that the Boston market price falls below $16.94. As a cost-saving measure, P.L. 109-171 reduced the payment rate from 45% to 34% effective for MILC payments in any month from October 2005 through August 2007. Under the law, a producer can receive a payment on all milk production during any month, but no payments are made on any annual production in excess of 2.4 million pounds per dairy operation. P.L. 110-28 maintained the payment rate at 34% for September 2007; the program expires after September 30, 2007.

The MILC program is akin to the Northeast Dairy Compact, which was in effect in the six New England states from 1997 until its expiration on September 30, 2001. However, under the expired dairy compact, dairy processors were required to pay the full difference between the $16.94 per cwt. fluid milk target price and any market price shortfall for fluid use milk in the compact region. The MILC program shifted the responsibility of the payment from the processor (and ultimately the consumer) to the federal government.

Although the MILC program originally expired on September 30, 2005, and was not extended until several months after that date, P.L. 109-171 allowed for USDA to make MILC payments retroactively for December 2005 through May 2006. For FY2006, USDA accepted applications in two phases. Eligible milk producers had until May 17, 2006, to sign up for payments to begin with one of the retroactive payment months (December 2005 through May 2006). After May 17, retroactive payments were no longer available, and a producer could only choose to begin receiving payments in the current month or a future month. (For a USDA fact sheet on the extended MILC program, referred to as the MILC-X program, see [http://165.221.16.19/dafp/psd/MILC.htm]).

MILC Payment History

USDA began accepting applications for the original MILC Program on August 15, 2002. (See **Table 1** for MILC payment history.) Monthly market prices were sufficiently low between December 2001 and August 2003 that MILC payments were made in every month during this period. Beginning in the late summer months of 2003, market farm milk prices greatly improved, rebounding from a 25-year low that prevailed throughout most of the early months of 2003. Hence, no MILC payments were required in September through December 2003. However, farm milk prices began to decline again in the latter part of 2003. Consequently, MILC payments resumed in January and February 2004. Market farm milk prices reversed their course in the late winter months and early spring of 2004, increasing to record high levels by the spring of 2004. Market prices remained sufficiently high from May 2004 through May 2005 so that no MILC payments were required over that time period. Market prices declined to the point that a small MILC payment ($0.03 per cwt.) was made for June 2005 milk production, the only payment that was made in all of FY2005. However, market prices declined in late 2005, triggering payments in each month from December 2005 through February 2007, which to date is the last month that MILC payments have been required. In August 2007, farm milk prices set a record high as the Class I Boston farm milk price reached $25.01 per cwt., which is $9.07 above the $16.94 per cwt. target price.

Table 1. Monthly Milk Income Loss Contract (MILC) Payment Rates

Month	Payment (per hundredweight)	Month	Payment (per hundredweight)
December 2001	$0.77	January 2004	$0.83
January 2002	$0.78	February 2004	$0.95
February 2002	$0.78	March 2004	$0.79
March 2002	$0.93	April 2004	$0.02
April 2002	$1.00	May 2004-May 2005	$0.00
May 2002	$1.09	June 2005	$0.03
June 2002	$1.20	July-November 2005	$0.00
July 2002	$1.38	December 2005	$0.04
August 2002	$1.45	Jan.-Feb. 2006	$0.105
September 2002	$1.45	March 2006	$0.41
October 2002	$1.59	April 2006	$0.84
November 2002	$1.39	May 2006	$0.925
December 2002	$1.43	June 2006	$1.00
January 2003	$1.41	July 2006	$0.80
February 2003	$1.56	August 2006	$0.925
March 2003	$1.75	September 2006	$0.965
April 2003	$1.82	October 2006	$0.43
May 2003	$1.79	November 2006	$0.44
June 2003	$1.78	December 2006	$0.43
July 2003	$1.76	January 2007	$0.03
August 2003	$1.22	February 2007	$0.10
Sept.- Dec. 2003	$0.00	March-Aug. 2007	$0.00

Source: USDA, Agricultural Marketing Service (AMS).

Federal Cost of MILC

Over the nearly five years of MILC program payment authority, its cumulative cost has been just under $2.5 billion — $1.8 billion in FY2003, $221 million in FY2004, $8.8 million in FY2005, $350.5 million in FY2006, and $114.7 million to date in FY2007. The FY2003 total includes two fiscal years worth of payments, since retroactive payments for FY2002 were made over the course of FY2003. FY2004 and FY2005 outlays were significantly lower because market farm milk prices were much stronger than in the two previous years, reaching a record high in the summer of 2004. Five states have accounted for just over one-half of the total payments made over the time period (see **Table 2**).

Table 2. MILC Payments Ranked by State, FY2003-FY2007

	FY2003	FY2004	FY2005	FY2006	FY2007	Total
Wisconsin	$372,042,880	$41,754,746	$1,369,537	$71,838,550	$23,906,505	510,912,218
New York	169,423,978	17,222,870	383,632	32,257,023	10,605,556	229,893,059
Pennsylvania	160,673,846	19,263,582	1,352,555	27,082,715	10,659,170	219,031,867
Minnesota	147,400,075	15,946,997	286,412	27,169,579	9,941,499	200,744,562
California	122,764,930	25,142,045	1,186,734	34,913,717	10,878,010	194,885,436
Michigan	75,828,865	8,799,034	316,507	15,563,328	5,234,795	105,742,529
Ohio	68,772,479	7,550,599	194,479	11,922,216	4,117,464	92,557,237
Iowa	60,686,427	6,512,172	236,348	11,629,909	4,216,210	83,281,065
Texas	38,793,821	6,282,787	199,362	9,024,192	2,833,816	57,133,978
Vermont	40,826,421	4,389,019	138,325	8,126,455	2,358,159	55,838,379
Idaho	33,211,800	5,496,523	371,276	8,719,484	1,699,743	49,498,825
Missouri	36,267,942	3,426,748	128,206	6,204,901	1,954,645	47,982,442
Illinois	34,170,687	3,818,084	158,274	6,144,976	2,098,120	46,390,142
Washington	30,869,213	5,064,507	111,841	7,539,782	1,855,240	45,440,583
Indiana	30,180,470	3,510,016	214,743	5,255,495	1,548,957	40,709,680
Kentucky	31,094,215	3,364,755	96,648	4,508,582	1,553,071	40,617,271
Virginia	29,876,611	2,895,202	324,527	5,174,178	1,588,842	39,859,361
Tennessee	24,469,076	2,545,783	62,281	3,853,946	1,389,069	32,320,156
South Dakota	20,355,578	2,148,893	31,015	3,738,836	1,073,656	27,347,977
Maryland	18,132,857	1,774,254	161,405	3,184,670	919,536	24,172,721
Oregon	16,295,432	2,178,087	35,910	4,036,387	1,163,919	23,709,736
Utah	15,782,707	2,027,249	-18,216	3,419,809	742,235	21,953,784
Georgia	15,764,327	1,930,999	31,078	3,136,152	1,041,666	21,904,223
Kansas	15,747,021	1,775,859	57,526	2,765,443	822,813	21,168,662
North Carolina	15,395,265	1,766,672	35,218	2,764,319	662,802	20,624,275
Nebraska	14,835,308	1,588,040	121,518	2,544,254	857,155	19,946,274
Puerto Rico	12,388,197	4,222,742	381,336	966,771	1,006,833	18,965,879
New Mexico	11,493,657	2,825,129	127,273	3,354,332	1,095,265	18,895,657
Oklahoma	12,519,405	1,307,138	50,983	1,958,338	597,487	16,433,350
Louisiana	11,430,924	1,066,703	31,415	1,517,821	449,378	14,496,240
Florida	9,783,286	1,761,420	31,601	2,342,573	677,334	14,596,214
Maine	10,250,302	984,845	13,481	1,904,303	585,737	13,738,668
Colorado	8,754,312	1,537,030	52,001	2,051,322	595,154	12,989,820
Arizona	7,641,285	1,526,600	163,838	2,138,679	540,790	12,011,193
North Dakota	8,964,621	1,111,814	56,389	1,291,575	514,520	11,938,920
Mississippi	8,916,963	880,166	66,520	1,189,543	370,512	11,423,703
Arkansas	7,499,823	665,206	27,202	1,011,333	242,656	9,446,219
Massachusetts	6,877,027	625,496	8,973	1,113,219	294,619	8,919,334
Connecticut	6,143,097	699,449	8,509	1,145,967	307,292	8,304,314
New Hampshire	5,095,796	515,693	11,031	973,494	306,335	6,902,350
Montana	4,901,714	519,903	21,112	1,023,945	239,646	6,706,320
South Carolina	4,779,476	529,781	52,581	914,359	275,777	6,551,974
Alabama	4,286,766	512,368	3,719	593,777	131,026	5,527,655
West Virginia	3,942,927	459,851	13,707	614,441	173,187	5,204,113
New Jersey	4,012,708	373,719	2,101	596,928	233,424	5,218,879
Nevada	2,014,582	351,358	25,597	589,067	56,619	3,037,224
Delaware	1,768,299	184,425	2,947	310,154	132,339	2,398,163
Wyoming	1,015,120	101,807	2,655	205,252	50,521	1,375,356
Hawaii	407,366	117,018	46,913	52,150	13,763	637,210
Rhode Island	451,901	36,430	390	58,558	24,271	571,550
Alaska	350,368	26,291	358	35,340	14,114	426,472
Virgin Islands	100,347	7,723	83	8,682	0	116,835
TOTAL	**1,795,452,502**	**221,125,627**	**8,789,854**	**350,480,820**	**114,651,255**	**2,490,500,058**

MILC Issues in the 2007 Farm Bill

Provisions in the House-Passed 2007 Farm Bill (H.R. 2419). The House-passed version of the 2007 farm bill (H.R. 2419) extends authority for the MILC program for five years, through September 30, 2012. It maintains the target price at $16.94 per cwt., and the payment rate would remain at 28% of the difference between the target price and the monthly market price, when it is lower.

The following are some of the issues that have shaped the debate on the MILC program.

MILC and the Baseline Budget. At its May 24, 2007, markup of the dairy title of the 2007 farm bill, the Livestock, Dairy, and Poultry Subcommittee of the House Agriculture Committee deferred consideration of extending the MILC program until full committee markup, because of a MILC funding issue that was being resolved on a separate track at the same time.

The 2002 farm bill originally required the MILC program to expire on September 30, 2005. A provision in the FY2006 omnibus reconciliation act (P.L. 109-171) extended the MILC program through September 30, 2007. In order to minimize the cost of program extension, P.L. 109-171 reduced the MILC payment rate to 0% in September 2007, the last month of program authority. Since the payment rate was set at 0% in the last month of the MILC program, CBO assumed that the program would continue at 0% beyond the program's authorized life. Hence, there was no money in the baseline budget for the MILC program beyond FY2007, thus posing a funding dilemma for reauthorizing the MILC program in the 2007 farm bill.

To resolve this issue, the FY2007 Iraq war supplemental act (P.L. 110-28, H.R. 2206), which was approved by both chambers on May 24, 2007 and signed by the President on May 25, amended the MILC authorizing statute so that MILC payments can be made at the current payment rate of 34% of the difference between the $16.94 per cwt. target price and the lower monthly market price, through September 30, 2007. This action effectively creates a budget baseline for the MILC program beyond its expiration date. CBO estimates that the projected total cost of the MILC program is approximately $1.24 billion for FY2008-FY2012, which is the expected timeframe of the next farm bill, or $2.4 billion over 10 years (FY2008-FY2017). These levels of spending have been added to the CBO baseline budget, thus giving the agriculture committees the needed funds to extend the MILC program in the 2007 farm bill if they choose, or to apply the funding to other farm bill initiatives.

Administration and Industry Proposals. On January 31, 2007, the Administration released a comprehensive 2007 farm bill proposal that included several recommendations for the MILC program. The Administration supports a continuation of MILC payments at the current target price of $16.94 per cwt. In order to defray the cost of MILC program extension, the Administration recommends that the payment rate be gradually reduced over a five-year period. It proposes maintaining the payment rate at the current level of 34% through FY2008, and then reducing it to 31% in FY2009, 28% in FY2010, 25% in FY2011, 22% in FY2012, and 20% in FY2013-FY2017. Annual payments per operation would continue to be restricted to 2.4 million lbs. under the proposal. It also would base payments on historical production rather than current production in order to forestall potential challenges to the program in the World Trade Organization (WTO).

The National Milk Producers Federation (NMPF), the largest trade association representing dairy farmer cooperatives, also supports a direct payment program for farmers. In order to make the program less susceptible to challenges in the WTO, NMPF supports a program based on the direct payment program for supported crops, whereby a milk producer would receive a direct payment (regardless of the level of market prices) of $0.50 per cwt. on the average production level of 2005 and 2006, up to $40,000 per farm. NMPF estimates that its proposal would cost $475 million per year more than the current MILC program.

The International Dairy Foods Association (IDFA), the largest trade association of dairy processors, opposes extension of the MILC program, contending that it works at cross purposes with the dairy price support program and contributes to the overproduction of milk and to high government costs. Instead, IDFA supports a dairy farm revenue insurance program that it says would provide a better safety net for farmers without distorting milk markets.

Regional Issues. Since its inception, the MILC program has been generally supported by milk producer groups in the Northeast and the Upper Midwest. Producer groups in the Northeast region viewed it as an alternative to the Northeast dairy compact. Upper Midwest producers preferred the new program to state compacts since the new program shares the price premiums nationally. Large dairy farmers have expressed concern that the MILC program causes excess milk production that in turn decreases market farm milk prices. They contend that this negatively affects their income, since their annual production is well in excess of the 2.4 million lb. payment limit, and any production in excess of 2.4 million pounds receives the market price and no federal payments. (Annual production of 2.4 million pounds is roughly equal to the annual production of a herd of approximately 120 to 130 dairy cows.)

Dairy Price Support Program

The Agricultural Act of 1949 first established the dairy price support program by permanently requiring 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. (See **Table 3**, below, for a recent history of spending on the dairy price support program and related activities.) Most recently, Section 1501 of the Farm Security and Rural Investment Act of 2002 (P.L. 107-171, the omnibus 2002 farm bill) authorized a 5½-year extension of the program through December 31, 2007, at the then-current support price of $9.90 per hundredweight (cwt.) of farm milk. Reauthorization of the program is being debated in the context of a new omnibus farm bill.

Historically, the supported farm 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 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.

Table 3. Dairy Price Support Purchases and Costs, 1980/81-2006/07

Marketing Year[a]	Net Removals Milk Equivalent (billion lbs.)[b]	Net Outlays (million $)	CCC Support Price ($ per cwt.)	CCC Purchases as Percentage of Production
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	280	10.05-9.90	0.2
1999-2000	0.8	569	9.90	0.5
2000-01	0.3	465	9.90	0.2
2001-02	0.2	622	9.90	0.1
2002-03	0.5	699	9.90	0.3
2003-04	NA	74	9.90	NA
2004-05	NA	- 104	9.90	NA
2005-06	NA	60	9.90	NA
2006-07	NA	22	9.90	NA

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.

NA = Not Available

In order to achieve the support price of $9.90 per cwt. of milk, USDA has a standing offer to processors to purchase surplus manufactured dairy products at the following prices: $1.05 per lb. for butter, $0.80 for nonfat dry milk, $1.1314 per lb. for block cheddar, and $1.1014 per lb. for barrel cheese. Whenever market prices fall to the support level, processors generally make the business decision of selling surplus product to the government rather than to the marketplace. Consequently, the government purchase prices usually serve as a floor for the market price, which in turn indirectly supports the farm price of milk at $9.90 per cwt.

Government purchases of surplus dairy products have been relatively small since late 2003, as market prices have remained above the support price during that period. In the early 1980s, the support price was $13.10 per cwt. and government purchases peaked at $2.6 billion in 1983. A gradual decline in the support price to the current level of $9.90 has significantly reduced the cost of the program from peak levels.

Price Support Program Issues in the 2007 Farm Bill

At issue in Congress this year is whether the dairy price support program should be extended beyond its December 31, 2007, expiration date. Funding is available in the budget baseline to extend the program at the current $9.90 per cwt. level of support, which CBO estimates will cost an average of $35 million per year. In its January 31, 2007, farm bill proposal, the Administration recommended the extension of the program, viewing it as a low-cost stabilizing influence on farm milk prices. It stated that many dairy producers see the need for a floor to be kept under farm milk prices to maintain an adequate milk supply and provide a safety net. Dairy processor groups have expressed concern that the dairy price support program in combination with MILC payments work at cross-purposes, by artificially stimulating milk production and causing persistent surpluses. They also question whether having the government as a guaranteed buyer of surplus products discourages investment to produce dairy ingredients (e.g. milk protein concentrates) that are increasingly in demand in the market.

WTO Implications. Separately, some policymakers are concerned that because of the way domestic price support programs are viewed under our trade obligations in the World Trade Organization (WTO), modifications to dairy support might be required under a new trade agreement. Although federal outlays for the dairy price support program have been relatively small (under $100 million) in recent years (see **Table 3**), the WTO measures the level of support differently.

Under current U.S. trade obligations, the aggregate measure of support for dairy is based on how much higher the domestic support price is set above a fixed world reference price (established in the WTO at a fixed level of $7.25 per cwt.). The imputed subsidy of $2.65 per cwt. (i.e., the $9.90 domestic support price less the $7.25 reference price) is applied to all domestic milk production. Using this formula, the U.S. has notified the WTO that the aggregate measure of support for the dairy price support program is more than $4.5 billion annually, and classifies it as "amber box" or the most trade-distorting category. The current U.S. proposal in the Doha Round is to reduce its total amber box support from the current $19.1 billion to $7.6 billion. With dairy support representing such a large percentage of the proposed new maximum, some have expressed interest in shifting future policy away from price support to some type of WTO-compliant direct payment that is decoupled from price and production.

Provisions in the House-Passed 2007 Farm Bill (H.R. 2419). As passed by the House, H.R. 2419 extends the dairy support program for five years (through December 31, 2012), but modifies the program so that it directly supports the prices of dairy products at mandated levels, rather than indirectly supporting the price of farm milk. Under the current price support program, the 2002 farm bill requires the farm price of manufactured milk to be supported at $9.90 per cwt, but allows USDA to administratively determine the mix of purchase prices for cheese, butter and powder that indirectly achieves the support price.

It requires USDA to purchase products at the following minimum prices: block cheese, $1.13/lb.; barrel cheese, $1.10/lb.; butter, $1.05/lb.; and nonfat dry milk, $0.80/lb. All of these proposed prices are equivalent to the purchase prices currently offered by USDA to support the overall price of milk at $9.90 per cwt. H.R. 2419 allows USDA to reduce the mandated prices only when government purchases of a product exceed a certain specified levels, and to sell back product to the marketplace only when market prices rise to 110% of the purchase price.

These modifications to the program in H.R. 2419 were based on a proposal submitted by the National Milk Producers Federation (NMPF). The NMPF supports a shift to mandated product price support stating that the current discretion given to USDA to establish purchase prices has "undermined the program's effectiveness."[2] NMPF also supports increasing the individual product purchase prices by between $0.02 to $0.06 per lb. However, the House decided to keep the minimum purchase prices fixed at current levels because of the budget implications of increasing the prices. NMPF also contends that a shift to a dairy product price support program might be viewed as less trade distorting in the WTO than the current support program. They maintain that under the proposal only the portion of milk production that goes into the production of the supported products would have to be notified to the WTO, and that fluid-use milk and milk used for unsupported manufactured products such as yogurt and ice cream would be exempt. However, the NMPF proposal does not contain an estimate of the cost of its proposal based on the WTO implicit dairy subsidy formula.

Federal Milk Marketing Orders

Background

The farm price of approximately two-thirds 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

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[2] See page 4 of "National Dairy Policy Direction: NMPF's 2007 Farm Bill Package" at [http://www.nmpf.org/files/NMPF_Policy_Direction.pdf].

uniform system of classified pricing throughout the market. Some states, California for example, have their own state milk marketing regulations instead of federal rules. Producers delivering milk to federal marketing order areas 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.

Federal orders regulate dairy handlers (processors) who sell milk or milk products within a defined marketing area by requiring them to pay not less than established minimum class prices 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, and sour cream (Class II products), cheese (Class III), and butter and dry milk products (Class IV products). These differences between classes reflect the different market values for the products.

Blend pricing allows all dairy farmers who ship to the market 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 four usage classes). Paying all farmers a single blend price is seen as an equitable way of sharing revenues for identical raw milk directed to both the higher-valued fluid market and the lower-valued manufacturing market.

Manufactured class (Class II, III and IV) prices are the same in all orders nationwide and are calculated monthly by USDA based on current market conditions for manufactured dairy products. The Class I price for milk used for fluid consumption varies from area to area. Class I prices are determined by adding to a monthly base price, a "Class I differential" that generally rises with the geographical distance from milk surplus regions in the Upper Midwest, the Southwest, and the West. Class I differential pricing is a mechanism designed to ensure adequate supplies of milk for fluid use at consumption centers. The supply of milk may come from local supplies or distant supplies, whichever is more efficient. However, local dairy farmers are protected by the minimum price rule against lower-priced milk that might otherwise be hauled into their region.

Proponents of federal orders argue that orders are necessary because dairy farmers have a competitive disadvantage vis-à-vis dairy handlers (processors) when it comes to determining prices that farmers receive for their raw, perishable milk. Critics contend that federal orders are arcane and outdated, and that the complexity of the system places dairy processors at a competitive disadvantage in the market.

Milk Marketing Order Issues in the 2007 Farm Bill

Dairy Forward Contracting. A forward contract is a cash market transaction in which a seller agrees to deliver a specific commodity to a buyer at some point in the future at a mutually agreed to price. A dairy farmer and a proprietary milk handler[3] theoretically can engage in a forward contract, whereby the farmer would

[3] A proprietary handler is a milk processing company that is owned privately or publicly by (continued...)

deliver milk to the processor at an agreed to price and future date of delivery. However, under current statute, if the monthly federal milk marketing order minimum price is above the forward contract price, the handler is still required to pay at least the federal order price for the milk. Proprietary handlers, therefore, have little incentive to enter into forward contracts, since they are prohibited from paying a price less than the federal milk marketing order minimum price. A pilot dairy forward pricing program was authorized by the FY2000 omnibus appropriations act, which USDA implemented from mid-2000 until its required expiration date of December 31, 2004.[4]

Dairy processor groups are seeking a provision in the 2007 farm bill that would exempt proprietary handlers from the minimum pricing requirements of federal orders when they enter into a forward contract with dairy farmers. Among the proponents is the International Dairy Foods Association, representing dairy processors. It contends that proprietary handlers should have the same ability to forward contract as dairy cooperatives. (Under current law, dairy cooperatives are exempt from having to pay the federal order minimum prices to its members.) Proponents contend that forward pricing is an effective risk management tool for both farmers and processors, allowing them to insulate themselves from the volatility of farm milk prices. Critics, which include the National Milk Producers Federation, are concerned that handlers might compel small farmers to participate in a contract, and possibly use the contract as a means of undermining the federal order pricing system.

Provisions in the House-Passed 2007 Farm Bill (H.R. 2419). H.R. 2419 authorizes a dairy forward pricing program that would be run in a similar manner as the temporary pilot program in 2000-2004. Like the original pilot program, the forward pricing program as proposed by H.R. 2419 would allow dairy farmers and cooperatives to voluntarily enter into forward contracts with milk handlers. Any payments made by milk handlers under the contract would be deemed to satisfy the minimum price requirements of federal milk marketing orders. The program would apply only to milk purchased for manufactured products (Classes II, III, and IV), and therefore would not include milk purchased for fluid consumption (Class I). H.R. 2419 would allow new contracts to be entered into until September 30, 2012, but no contract could extend beyond September 30, 2016.

Streamlining Rulemaking Procedures. Unlike the dairy price support program and the milk income loss contract program, federal milk marketing orders are permanently authorized and therefore do not require periodic reauthorization by Congress. Instead, changes to federal milk marketing orders are handled administratively by USDA's Agricultural Marketing Service. The authorizing statute for federal milk marketing orders requires USDA to use formal rulemaking procedures to make changes to orders. Any interested party can petition USDA to

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[3] (...continued)
investors other than milk producers. This structure differs from a cooperative, which is owned and operated by its farmer members.

[4] For more information on the pilot program, see the USDA Agricultural Marketing Service website at [http://www.ams.usda.gov/dairy/for_contr_pilot.htm].

create a new order or amend an existing one. The terms of a new or amended order are developed through public participation (producers, processors and consumers) in hearings held by USDA prior to the issuance of the order. USDA analyzes the hearing records and then recommends the terms and provisions of milk marketing orders. If two-thirds of the voting producers approve a new or an amended marketing order, the Secretary then approves and issues the order.

Some dairy producer groups have expressed concern that this rulemaking procedure can take many months and sometimes years to reach a conclusion and that the process needs to be streamlined. USDA admits that the process is time consuming, but counters that it provides for maximum industry participation and transparency. The International Dairy Foods Association (IDFA) contends that the rulemaking process prevents dairy farmers and processors from competing with other food and beverage industries that are not faced with government intervention. IDFA supports the elimination of federal milk marketing orders, considering the system to be outdated and unresponsive to market forces, and proposes that Congress should establish a blue ribbon commission of stakeholders and experts to review the federal order system in its entirety.[5]

Provisions in the House-Passed 2007 Farm Bill (H.R. 2419). As passed by the House, H.R. 2419 adopted several revisions to federal order amendment procedures that include time limits for specific actions. Within 30 days of receiving a request for a hearing, USDA would be required to either deny the request or issue notice of a hearing. The hearing would then have to begin within 60 days and conclude no more than 90 days after receipt of the request. The proponents of an amendment would be required to submit written testimony at least seven business days before the hearing date. The Secretary would be required to issue a recommended decision on a proposed amendment not later than 90 days after the date set for the submission of post-hearing findings, and then issue a final decision no more than 60 days after the recommended decision. Also included in H.R. 2419 is the authorization of a blue ribbon commission on the future and efficacy of federal milk marketing orders.

Dairy Import Assessment

The Dairy Producer Stabilization Act of 1983 (7 U.S.C. 4501-4514) authorized a national dairy producer program for generic dairy product promotion, research, and nutrition education. The program is funded through a mandatory 15-cent per hundredweight assessment on all milk produced and marketed in the 48 contiguous states. Section 1505 of the 2002 farm bill (P.L. 107-171) amended the 1983 act requiring that the 15-cent assessment be collected on all imported dairy products. Section 1505 also required USDA to consult with the Office of the U.S. Trade Representative (USTR) before implementing the assessment on imports to ensure that the new requirement is consistent with U.S. international trade obligations. After consulting with the USTR, the Secretary of Agriculture determined that a mandatory

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[5] See page 22 of the International Dairy Foods Association's Blueprint for the 2002 Farm Bill, "Ensuring a Healthy U.S. Dairy Industry" at [http://www.healthydairyindustry.org].

dairy import assessment is not permissible, since Alaska and Hawaii are exempt from the domestic assessment. According to USDA, the exemption treats some domestic producers more favorably than importers, thereby violating U.S. trade obligations. Hence, USDA has never implemented the import assessment.

Provisions in the House-Passed 2007 Farm Bill (H.R. 2419). H.R. 2419 adopts the Administration's proposal to ensure that the current 15-cent assessment applies to Alaska, Hawaii and Puerto Rico. The Administration contends that this proposed statutory change then would make the definition of the United States consistent with the definition used by the USTR and U.S. trading partners, thus allowing them to implement the assessment. The import assessment is supported by most dairy producer groups. However, milk producers in Alaska and Hawaii are opposed to any definition change that would require them to contribute to the program. Dairy importers and processors are opposed to the import assessment, contending that it is an unfair tax on imported products which they say could be challenged as trade distorting in the World Trade Organization, regardless of whether Alaska and Hawaii are included.