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Section 102: The California Make Allowance Issue

by

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## **Section 102: The California Make Allowance Issue**

Ed Jesse<sup>1</sup>

### ***Introduction***

Section 102 refers to a section of the 1990 Food, Agriculture, Conservation and Trade Act of 1990, which states that:

"...no state shall provide for (and no person shall collect, directly or indirectly) a greater allowance for the processing of milk (hereafter referred to as a "make allowance") than is permitted under a federal program to establish a Grade A price for manufacturing butter, nonfat dry milk, or cheese."

Section 102 is directed at the California state milk pricing system, which sets prices for milk used for cheese at levels that are well below those experienced in other parts of the country. Proponents of Section 102 argue that this provides an unfair competitive advantage to California cheese plants: They can buy milk cheaper than plants in other regions, yet enjoy the same finished product prices. Opponents of Section 102 contend that the large make allowances built into the California pricing system are in line with higher costs experienced by manufacturers in California, and that they are necessary to ensure sufficient growth in processing capacity to match the rapid growth in California milk production.

This paper examines the Section 102 debate from the perspective of the Upper Midwest. It begins with an explanation of make allowances in general and how they are used in California's milk pricing system. Rationale offered in defense of the large California make allowance are presented and evaluated. The effect of the current allowances and the likely impact of their reduction are discussed. The discussion focuses primarily on prices for milk

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used in cheesemaking and exclusively on the make allowance issue as it pertains to the California milk pricing system.<sup>2</sup>

### ***Make Allowances***

The term, "make allowance," has its origins in the Dairy Price Support Program (DPSP). The Agricultural Adjustment Act of 1933 directs the Secretary of Agriculture to support the price of manufacturing milk through the purchase of manufactured dairy products by the Commodity Credit Corporation (CCC). The DPSP doesn't legally require plants to pay the announced support price. Rather, the CCC sets prices for manufactured products so that plants selling these products to the CCC can achieve returns that are, on average, sufficient to allow them to pay their patrons the support price. This requires an assumption about plant manufacturing margins; that is, the make allowance.

For example, the current support price is \$10.10 per hundredweight for milk of average butterfat test (3.67%). The CCC purchase prices for butter and nonfat dry milk are \$.65 and \$1.034 per pound, respectively. A hundredweight of milk at average test is assumed to yield 4.48 pounds of butter and 8.13 pounds of nonfat dry milk. Hence, a butter/powder plant selling to the CCC would receive \$11.32 per hundredweight of milk processed ( $4.48 \times \$0.65 + 8.13 \times \$1.034$ ). That means the butter/powder make allowance is \$1.22 -- plants getting \$11.32 in product value from the CCC should be able to cover their costs and pay the \$10.10 support price for raw milk.

For cheddar cheese in 40-60# blocks, the CCC make allowance is \$1.37 per hundredweight and the assumed cheese yield per hundredweight of milk is 10.1 pounds. But it is also assumed that cheese plants will typically recover one-quarter of a pound of butter from butterfat in whey. At today's CCC butter price of \$.65 per pound, the whey fat is valued at 16 cents per hundredweight. That amount is subtracted to leave a net make allowance of \$1.21 -- plants selling block cheese to the CCC at \$1.12 per pound are assumed to be getting enough cheese and whey byproduct revenue to allow them to pay the \$10.10 per hundredweight support price (10.1 pounds of cheese @ \$1.12 plus 0.25 pounds butter @ \$0.65 minus \$1.37 make allowance equals \$10.10 per hundredweight).

DPSP make allowances have not been changed since 1979, and are generally believed to be less than actual manufacturing costs. On the other hand, the CCC cannot, by law consider the value of nonfat solids in whey. Sale of dry and condensed whey products adds to the ability of cheese plants to pay for milk, which means that the difference between cheese and whey butter revenue per hundredweight of milk used for cheesemaking and the

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<sup>2</sup> Adoption of Class III-A pricing in most federal orders has yielded federal order prices for milk used in butter/powder that are very close to the California (4a) price. Hence the major impact of implementing Section 102 would be on cheese. Section 102 could also affect milk pricing arrangements in a few other states, but the associated volume of milk is minor in comparison to California.

value of milk is generally less than the \$1.37 Federal Dairy Price Support Program make allowance. Experience since 1986 is shown in Figure 1, which illustrates the difference between gross receipts, not counting any value for nonfat whey solids, and milk cost per hundredweight. Gross receipts are measured as the sum of 10.1 pounds of cheddar cheese priced at the monthly average National Cheese Exchange block cheddar price and 0.25 pounds of butter priced at the Chicago Mercantile Exchange Grade A price. Milk cost is measured as the M-W price adjusted to a 3.67 percent butterfat basis. The imputed cheese margins are highly variable, averaging \$1.25 per hundredweight over the period January 1986 through February 1994.

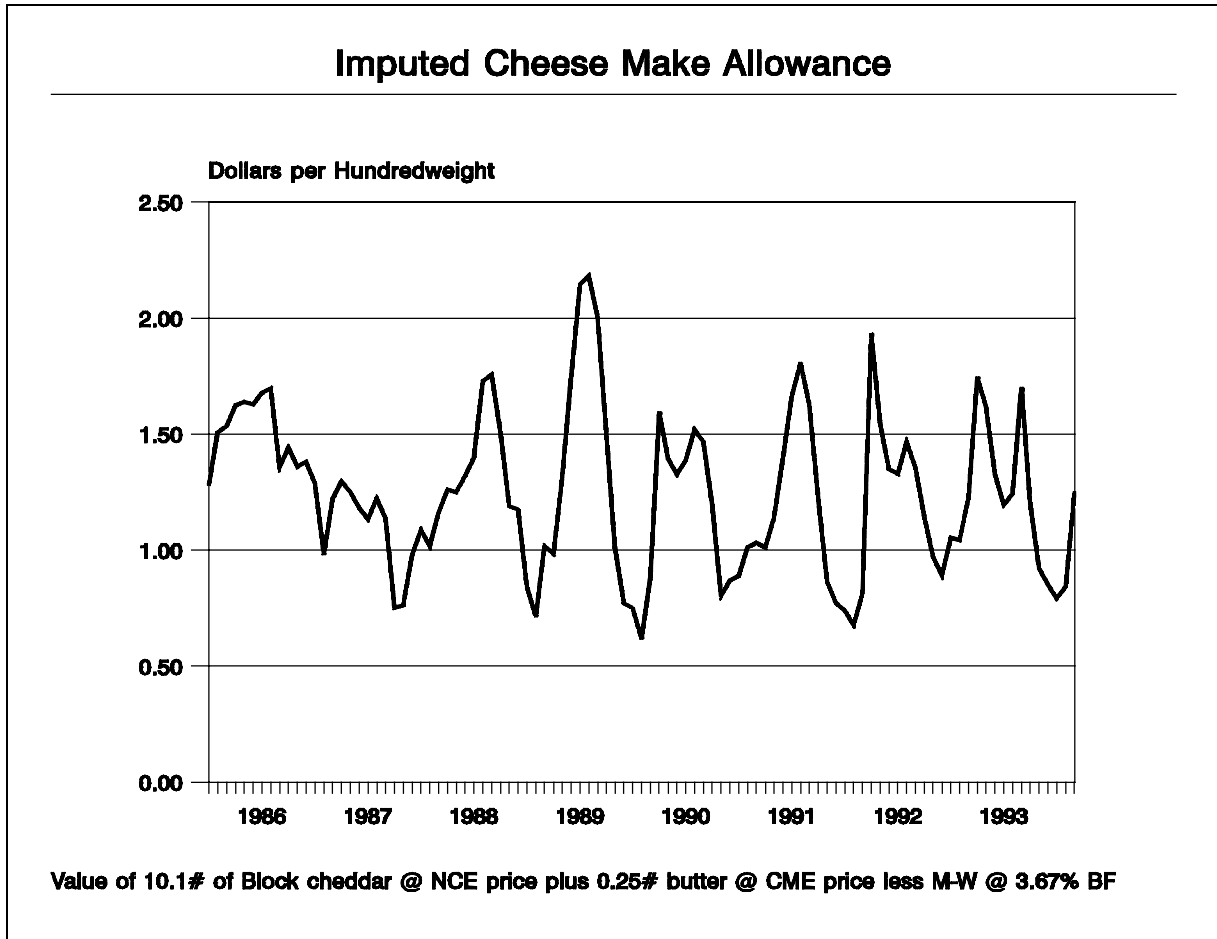


Figure 1

In summary, the DPSP make allowance is merely an *assumption* about manufacturing costs that is used to derive product prices given a raw milk price. Plants don't receive the DPSP make allowance; actual plant manufacturing margins are related to competitive conditions in the local milk market whether cheese is sold commercially or to the CCC.

Make allowance has a substantially different meaning in California. California operates a state milk pricing program that is similar to but separate from the federal order system that prices most of the Grade A milk in the U.S. Federal orders use the M-W price for the current month as the minimum price for milk used to make cheese. The M-W price is an estimate of the Grade B milk price in Minnesota and Wisconsin. It is a competitively-determined price that reflects what manufacturing plants receive for butter, powder, and cheese less their actual manufacturing margins. When product prices are close to CCC prices, then the M-W price will be close to the support level. And all plants regulated under federal orders will have the same minimum raw product cost for manufacturing milk.

The California milk pricing program also sets prices for milk used for manufacturing, but it doesn't base that price on the M-W price. Classified prices in California are specified for milk components. There are five classes of milk; Class 4b is milk used for cheese. Each month, a Class 4b price per pound of butterfat and solids-not-fat is announced based on a formula that considers selling prices for cheese, byproduct values, product yields, and make allowances associated with making cheese and whey butter. In effect, the Class 4b price per hundredweight of milk is what is left over after subtracting the make allowance from cheese and whey butter values associated with a hundredweight of milk.

What California does with the make allowance is essentially backward from what is done under the Dairy Price Support Program. The DPSP establishes product prices by adding a make allowance to the announced support level. The product prices are fixed and the manufacturing milk price to farmers varies depending on whether marketplace prices for butter, powder, and cheese are at or above CCC prices and on whether the make allowance is sufficient to cover actual plant costs. The California milk pricing program establishes milk prices by subtracting a make allowance from product prices. The make allowance is fixed and the milk price to farmers depends on product prices.

The California make allowances are set through a hearing process, but related to actual plant cost experience. Costs are estimated through periodic surveys of plants making butter/powder and cheese. Estimates include (non-milk) ingredients, packaging, processing labor, other processing costs, and general and administrative costs. A return on investment using the prime rate of interest is also estimated.

The current California make allowance for cheese is \$.195 per pound. The butter make allowance is \$.097 per pound. California assumes that cheddar cheesemaking yields 0.27 pounds of whey cream butter and 9.8 pounds of cheese per hundredweight of milk. Hence, the make allowance per hundredweight is \$1.94 ( $$.195 \times 9.8$  plus  $$.097 \times 0.27$ ). This compares to the \$1.37 per hundredweight used by the CCC in calculating the block cheddar cheese purchase price and even smaller manufacturing margins actually experienced by most plants in the Upper Midwest.

California Department of Food and Agriculture cost estimates for the period May 1991 to April 1993 indicate that the weighted average cost to produce cheddar cheese in California

was \$.194 per pound (not including return on investment, estimated to average \$.0086 per pound). The range in costs among the 10 survey plants (accounting for more than 97 percent of the cheddar cheese produced in the state) was from \$.152 to \$.486 per pound. The make allowance of \$.195 covered the costs of plants manufacturing 39 percent of total California cheddar cheese volume during this period.

In summary, the California milk pricing system sets the price for milk used to make cheese by subtracting a make allowance from cheese and butter prices. This make allowance is considerably larger than what is experienced by cheese plants in other regions of the country. Hence, California cheese plants enjoy lower milk costs than plants in other states.

### ***Section 102***

Attempts by the Upper Midwest to force the State of California to reduce its state Class 4 make allowance date to the late 1980s. In 1987 and 1988, the Wisconsin Federation of Cooperatives, acting on behalf of fifteen Wisconsin dairy cooperatives, testified in support of lower make allowances at California Department of Food and Agriculture hearings. The Federation witness argued that markets for butter, nonfat dry milk, and cheese were national in scope. The large make allowances under the California milk pricing program allowed California manufacturing plants a substantial margin of profit in competing with plants in other regions, where the prices of milk used to make butter, nonfat dry milk, and cheese were higher. This allowed California plants an unfair advantage in supplying manufactured products throughout the country.

At these hearings, most of the testimony was contrary to the Federation's position. Only a few California dairy farmers supported lower make allowances. Cooperatives and proprietary manufacturers overwhelmingly defended existing levels or argued in support of even higher make allowances. Consequently, efforts to achieve meaningful reductions in the make allowances through the California hearing process proved unsuccessful.

The next step in seeking a reduction in the California make allowance was via the U.S. Congress. Congressman Steve Gunderson (R-WI) led an eventually successful effort to place a cap on the make allowance in the 1990 farm bill. Section 102 was the result.

Section 102 says simply that states that regulate farm milk prices cannot provide plants a make allowance that is greater than what is provided under a federal program. It was left to USDA to interpret this language and develop rules to implement Section 102. This has proven to be a contentious and lengthy process.

Following a regulatory impact analysis released in November 1991, USDA issued proposed rules for implementing Section 102 in June 1992.<sup>3</sup> The rules interpreted the law quite literally, proposing that plants operating in states that set milk prices would be judged to be out of compliance with Section 102 if they received make allowances that were greater than the \$1.22 (butter/powder) and \$1.37 (cheese) per hundredweight values used to set product prices in the Dairy Price Support Program.

USDA received about 240 comments on its proposed rules, most of them negative. The agency subsequently revisited the issue. It published an amended regulatory impact analysis in December 1992 that considered other implementation options. In November 1993, it issued supplementary proposed rules and asked for comments until April 1, 1994.

The amended rules look at both the state and the milk plant within the state in determining compliance with Section 102. They also propose a different method for determining compliance. A state would be in compliance if the prices it set for milk used to make butter/powder and cheese were at or above the Class III-A and Class III prices, respectively, for the federal milk marketing order operating in the competitive area. In the case of California, the reference Class III-A price would be the Class III-A price for western orders and the reference Class III price would be M-W price.

If a state were in compliance, then milk plants would automatically be judged to be in compliance. If a state were not in compliance, then the compliance burden is on the plant and the same rules apply: The plant must pay at least the Class III-A or Class III price to be in compliance. If not in compliance, then plants are subject to a penalty equal to twice the allowable make allowance. While not precisely indicated, the allowable make allowance would be related to reported product prices, assumed yields, and Class III-A and Class III prices.

There are some unusual aspects to the revised proposed rules. First, it appears that no penalties apply to states that refuse to comply with Section 102: The onus is on plants to comply if the state in which the plant operates does not. Second, plants are not penalized unless a complaint is filed by a dairy farm patron supplying the plant. Finally, and most important, cooperatives and their customers are exempt from penalties. The proposed rules specifically state that:

"...a cooperative member could not file a complaint against the member's cooperative, and a cooperative member could not file a complaint against a milk plant to whom the member's cooperative sells milk."

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<sup>3</sup> It is interesting to note that the initial issuance of proposed rules occurred 18 months after passage of the 1990 Farm Bill. Section 102 stated that the make allowance cap must be in place 12 months following passage of the bill.

Even before the period for receiving comments on the proposed implementation rules expired, the State of California filed suit to prevent implementation of the rules. The State was joined in the suit by proprietary California manufacturers arguing that implementation would result in severe economic penalties on the California dairy industry.

### ***Rationale for the California Make Allowances***

California dairy interests defend their high make allowances on several grounds. Points used in their justification and related critiques follow:<sup>4</sup>

- (1) *High make allowances are needed to offset Class 1 (fluid milk) balancing costs that are not covered by Class 1 differentials.*

Federal milk marketing orders set Class I (fluid milk) prices by adding a Class I differential to the (lagged) M-W price. Until recently, California's milk pricing system used a formula to set Class 1 (fluid) milk prices that did not involve a differential in the sense that the term is used in federal orders. However, differentials can be imputed as the difference between California's Class 1 and Class 4 prices.

Figure 2 compares the difference between the California Class 1 price and Class 4b price and the Class I differential for the Chicago Regional order. The Chicago Class I differential is fixed at \$1.40 per hundredweight. The imputed California Class I differential is highly variable, since Class 1 and Class 4 prices do not move together. It has recently averaged about \$2.50 per hundredweight, or about \$1.00 higher than the Chicago differential.

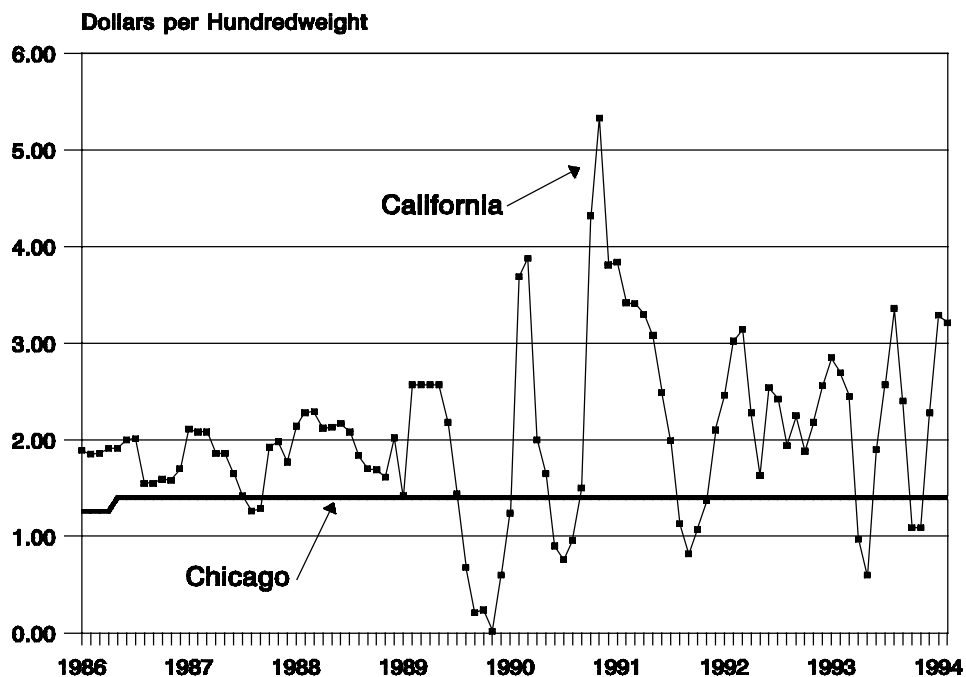
Figure 3 shows the actual California Class 1 price in comparison to the Class I price in the Chicago order. Until 1991, California Class 1 prices were generally lower than Chicago Class I prices. Since then, California prices have generally been higher; in 1991 often more than \$1.00 per hundredweight higher. A Class 1 pricing formula change effective January 1994 is expected to keep the California Class 1 price consistently above the Chicago order Class I price. Moreover, part of Class 1 revenues is now pooled and distributed to all producers rather than allocated exclusively to holders of Class 1 quota. In other words, California is now using proceeds from Class 1 milk sales to subsidize production of Class 4 milk.

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<sup>4</sup> These points of justification were cited in testimony presented at a California Department of Food and Agriculture hearing on make allowances held in Sacramento on June 21, 1988.



## Class I Differentials: California and Chicago



For California, Class I differential is Class I price less current month 4b price

Figure 2

Given the level of Class 1 prices in California and the difference between Class 1 and Class 4, there is little merit to the argument that low Class 4 prices are needed to offset high balancing costs. Even if balancing costs were not being fully covered by Class 1 values, the solution is to raise Class 1 prices, not to lower the price for milk used in another class.

- (2) *California plants have inherently high manufacturing costs. High make allowances are necessary to ensure that plants can compete with those in other regions.*

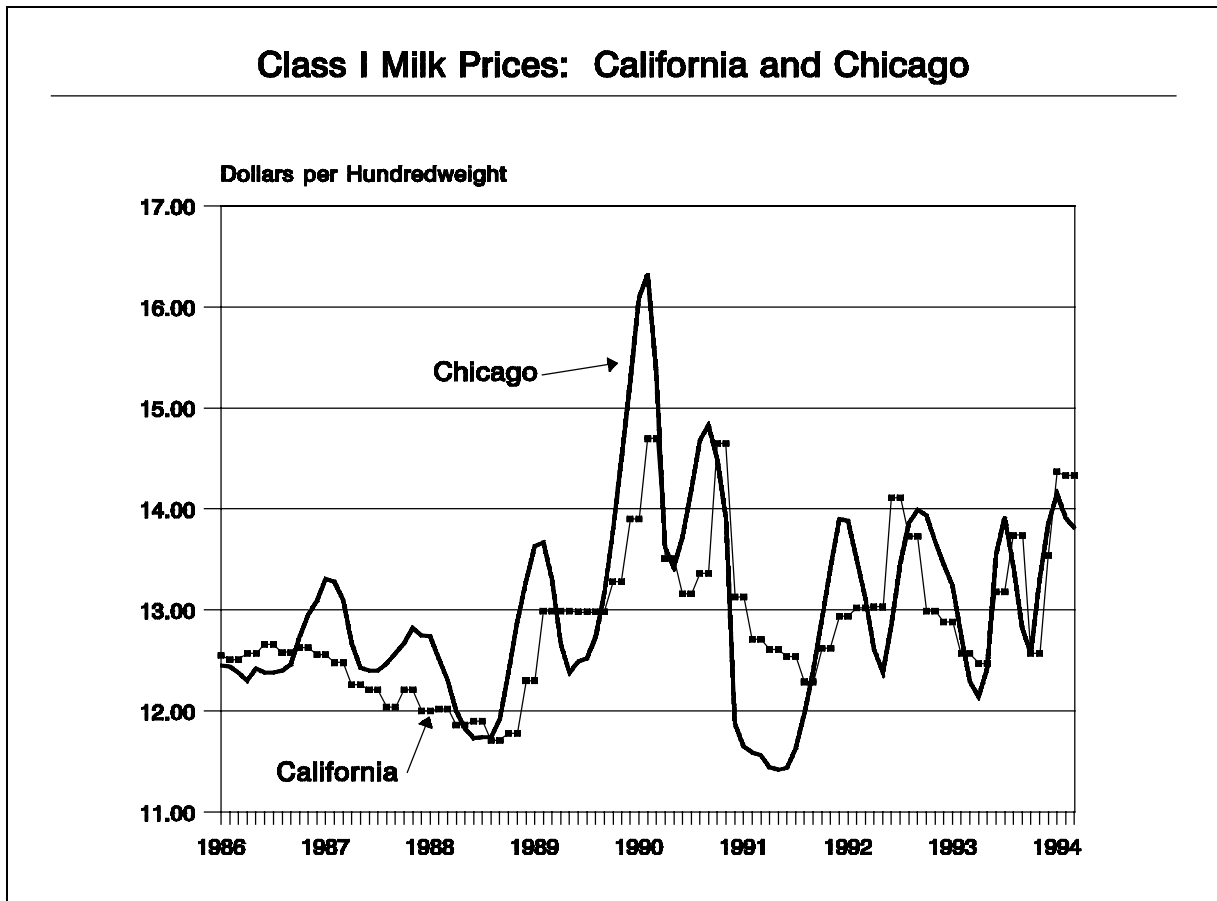


Figure 3

Research partly supports this contention.<sup>5</sup> Wage rates for manufacturing labor are about \$2.00 per hour higher in California than in Wisconsin. California also experiences higher utility costs (electricity, natural gas, water and sewer). For equal size plants, cheese manufacturing costs in California are about 12 percent higher than in Wisconsin.

But cheese plants are not equal size in the two states. In 1992, 17 plants manufactured about 250 million pounds of cheddar cheese in California. Ninety five plants manufactured about 800 million pounds of cheddar in Wisconsin. The associated average volume was 14.7 million pounds in California, 8.4 million pounds in Wisconsin. There are substantial economies

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<sup>5</sup> See R. Buekeboom and E. Jesse, "Regional Competitive Advantage in the U.S. Cheddar Cheese Market," Marketing and Policy Briefing Paper No. 38, Department of Agricultural Economics, University of Wisconsin-Madison, November 1991.

to scale in cheesemaking, suggesting that lower costs associated with larger size in California offset unit cost disadvantages when size is held constant.

- (3) *California cheese yields are lower than other regions. The high cheese make allowance is necessary to counteract lower yields.*

Cheese yields are related to fat and protein tests in milk used to make cheese. There is no evidence that California milk suffers from deficient fat or protein. Dairy Herd Improvement Association data indicate that state average fat and protein tests for California and Wisconsin are practically identical. A study of regional milk composition by Dave Barbano in 1984 showed that both the butterfat and protein content of California milk were slightly higher than Wisconsin milk.<sup>6</sup> Theoretical cheddar cheese yields for California based on milk composition were 0.06 pounds per hundredweight higher than for Wisconsin.

There is no apparent reason that California should experience lower cheese yields than other regions unless plant efficiency is exceptionally low or factors other than milk composition are reducing yields.

- (4) *The high make allowances are necessary to encourage added plant capacity to handle expanding milk production in the state.*

This justification has merit to the extent that large make allowances and expanding milk production are independent. That may not be the case. Critics of California's Class 4 pricing system argue that high profits associated with large make allowances lead to aggressive recruitment of additional milk. If make allowances were reduced, then plants would be less willing to accept additional milk.

- (5) *High make allowances are necessary to allow plants to recover research and development costs for new cheese varieties and whey products and to meet stringent environmental regulations.*

Manufacturing margins that are greater than operating costs are certainly necessary to promote research and development. At issue, however, is whether these margins should be regulated or result from competitive forces. If regulated margins are too high, resulting in excessive returns to assets relative to other investments, then there will be an inequitable sharing of returns between dairy farmers and manufacturers and abnormal incentives to increase manufacturing capacity.

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<sup>6</sup> Barbano, David M., "Seasonal and Regional Variation in Milk Composition in the U.S.," Paper presented at the 1990 Cornell Nutrition Conference for Feed Manufacturers, October 23-25, 1990, Rochester, NY.

- (6) *High make allowances are a good way to stimulate economic development.*

Make allowances that are higher than warranted by economic conditions represent a tax on dairy farmers in the form of lower milk prices. Taxing dairy farmers to support economic development represents, at best, a creative fiscal policy.

### ***Effect of California Make Allowances***

Regulated make allowances effectively transfer price risk from manufacturers to farmers. A fixed make allowance means that changes in product prices are transferred directly to milk prices; processing firms do not take up any of the slack. This occurs regardless of the level of the make allowance. The absence of risk, by itself, encourages investment. Lenders and investors are motivated by low risk.

When make allowances are high enough to create excess manufacturing profits, another price distortion element is introduced. The sharing of returns from product sales between farmers and manufacturers is determined mechanically instead of competitively. Investment in manufacturing capacity is further stimulated.

More important, the effects cannot be confined to the state doing the regulating. California is the leading dairy state. If its cheese manufacturers can procure milk cheaper than manufacturers in other states, then competition in national cheese markets is affected.

California's Class 4b make allowance has caused the cost of milk to California cheesemakers to fall increasing below the M-W price, which represents the minimum cost of milk to cheesemakers regulated under federal orders. Figure 4 shows that until the early 1980s, the 4b price averaged very close to the M-W price. By 1990, the 4b price had fallen to about \$1.00 under the M-W price as the make allowance for cheese was increased. In other words, federal order-regulated cheese plants have a milk cost that is about a dime higher than California cheese plants.

To make matters worse for Upper Midwest cheesemakers, prices for Grade A milk used to make cheese in the Upper Midwest have increased steadily above the M-W price (Figure 5). Since 1984, the difference between what Wisconsin cheese plants pay for Grade A milk used to make cheese and the M-W price has grown from 40 cents to \$1.00 per hundredweight.<sup>7</sup>

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<sup>7</sup> Wisconsin Grade A manufacturing milk prices are taken from a series of studies conducted by the Market Administrators Office of the Upper Midwest federal milk marketing order. They reflect reported pay prices for regulated plants in Wisconsin that are engaged predominantly in manufacturing less the order pool draw received by those plants.

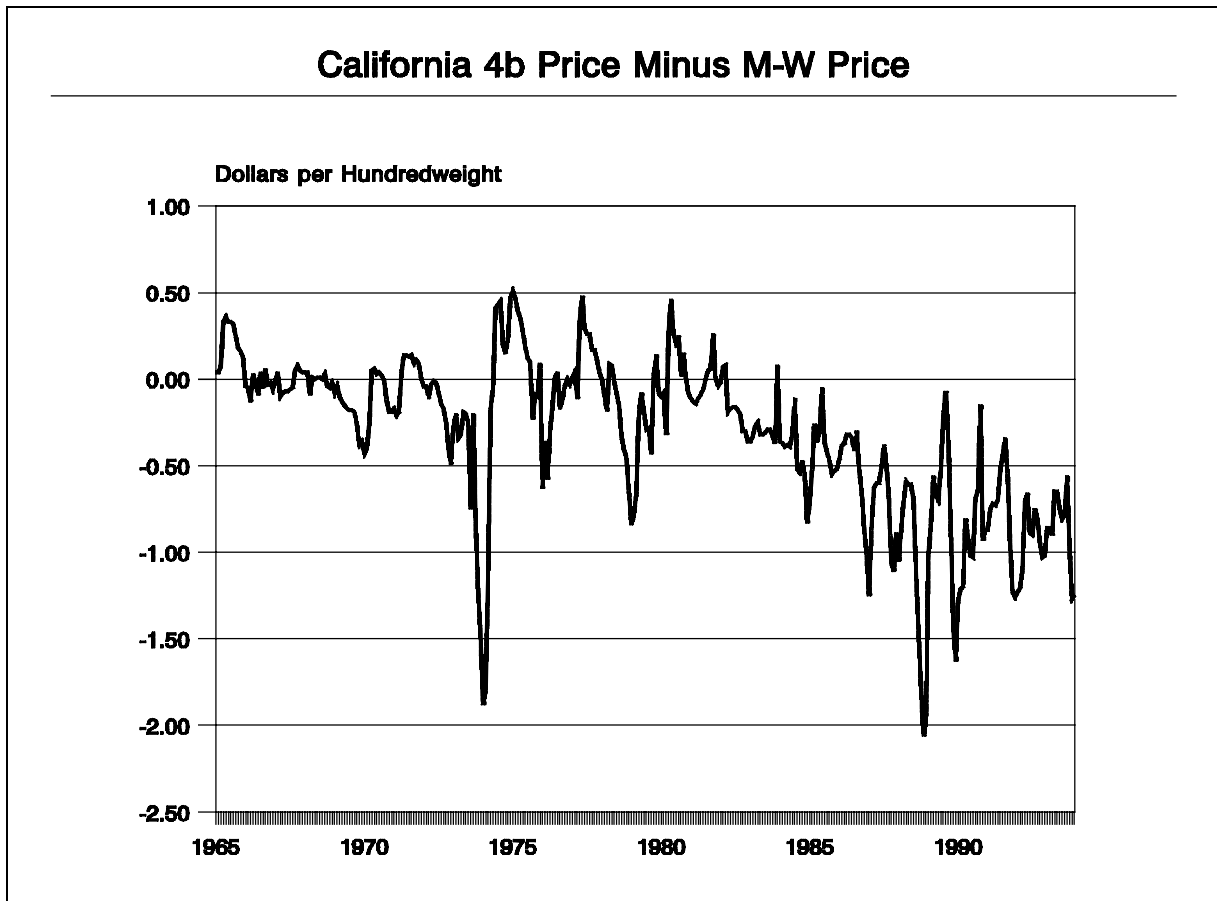


Figure 4

These opposite trends in cheese milk prices relative to the M-W price mean that the cost of milk to make cheese in Wisconsin has become increasingly greater than the cost of milk to make cheese in California. Figure 6 shows the combined effect. Over the last 10 years, the difference in raw product cost has increased from a 50 cents per hundredweight disadvantage to Wisconsin to a \$2.00 disadvantage. About one-half of this disadvantage is attributable to California's make allowance for cheese. The remainder comes from intense plant competition for a declining milk supply in Wisconsin.

California's raw product cost advantage can offset substantially higher manufacturing costs. It can also offset the state's freight disadvantage in servicing large eastern population centers. To illustrate, assume the benefit of doubt by conceding higher manufacturing costs and lower cheese yields to California. Assume a processing cost per hundredweight of \$2.02 for California and \$1.81 for Wisconsin.<sup>8</sup> Use the California 4b pricing formula yield of

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<sup>8</sup> These are estimated costs for large (960,000 pounds per day milk intake) cheese plants from Buekeboom and Jesse. Note that the California cost is higher than the 4b make allowance.

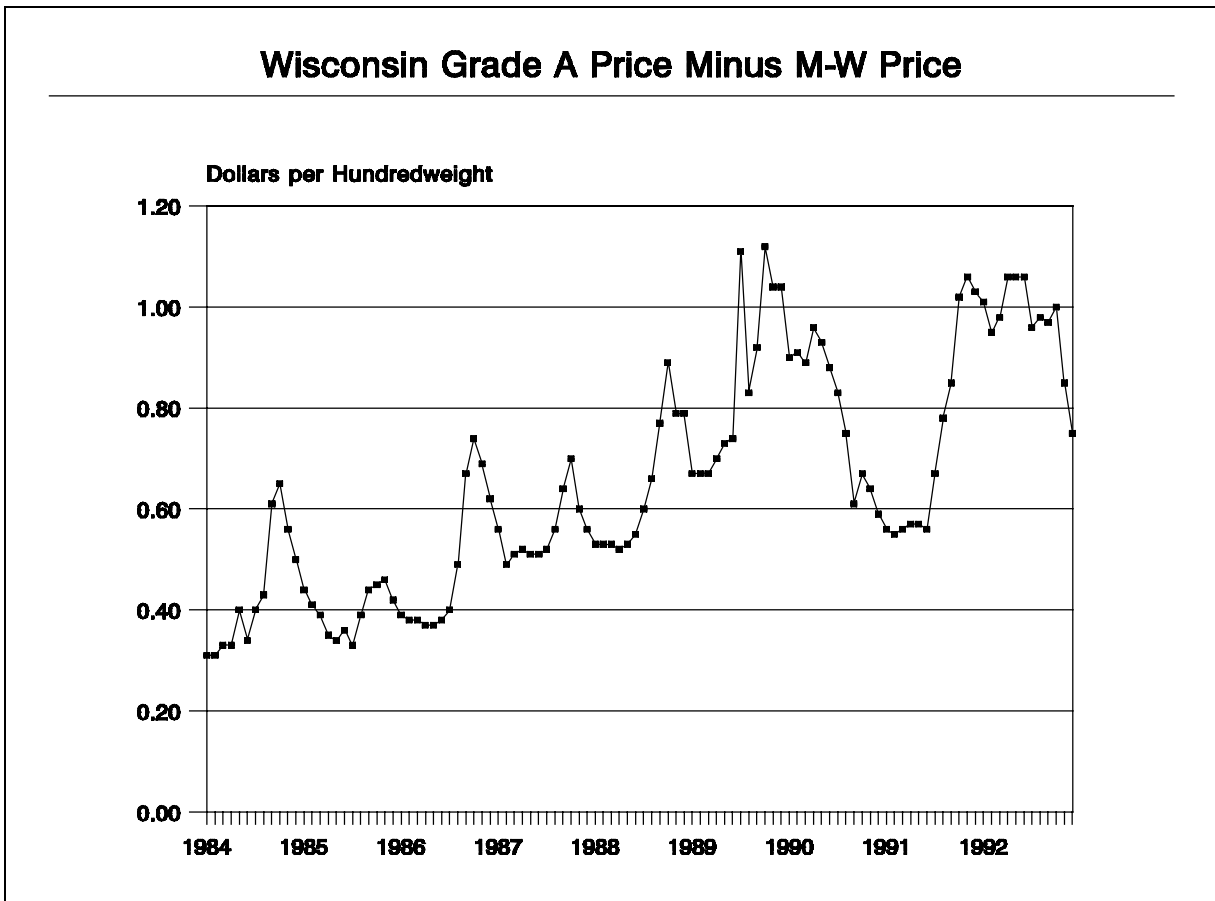


Figure 5

9.8 pounds of cheddar per hundredweight in California and 10.1 pounds in Wisconsin. The cost of Grade A milk for cheese in 1992 was \$10.94 per hundredweight in California; \$12.87 in Wisconsin. With these values, the total cost to manufacture a pound of cheddar cheese is \$1.32 in California and \$1.45 in Wisconsin

Cheese freight costs per pound can be added to these f.o.b. plant costs to calculate delivered costs. Table 1 was derived using freight costs reported in Buekeboom and Jesse. Note that, despite assumed manufacturing costs that are higher than the 4b make allowance and assumed cheese yields that are 3 percent lower than Wisconsin, California enjoys a delivered cost advantage in every part of the U.S. The advantage ranges from 9-18 cents per pound.

Table 1  
Delivered Cost Advantage for Cheddar Cheese:  
California vs. Wisconsin

<u>City</u>	<u>\$/Pound</u>
Atlanta	0.10
Boise	0.17
Chicago	0.09
Dallas	0.10
Denver	0.12
Kansas City	0.11
Louisville	0.09
Memphis	0.10
Miami	0.09
Minneapolis	0.10
New Orleans	0.11
New York	0.12
Phoenix	0.16
Pittsburgh	0.09
San Francisco	0.18
Seattle	0.16

***Effect of Section 102***

Predicting the net effect of implementing Section 102 is difficult because there would be different and conflicting effects on California plants and dairy farmers. There would also be different short-run and long-run effects.

The intended purpose of Section 102 is to force California manufacturing plants to pay milk prices that are similar to those in other parts of the country. Higher milk costs would restrict plant profitability and reduce demand for milk. But at the same time, higher milk prices would stimulate supply. Hence, even in the abstract, the effect of implementing Section 102 is unclear: Manufacturers would want less milk but producers would want to supply more.

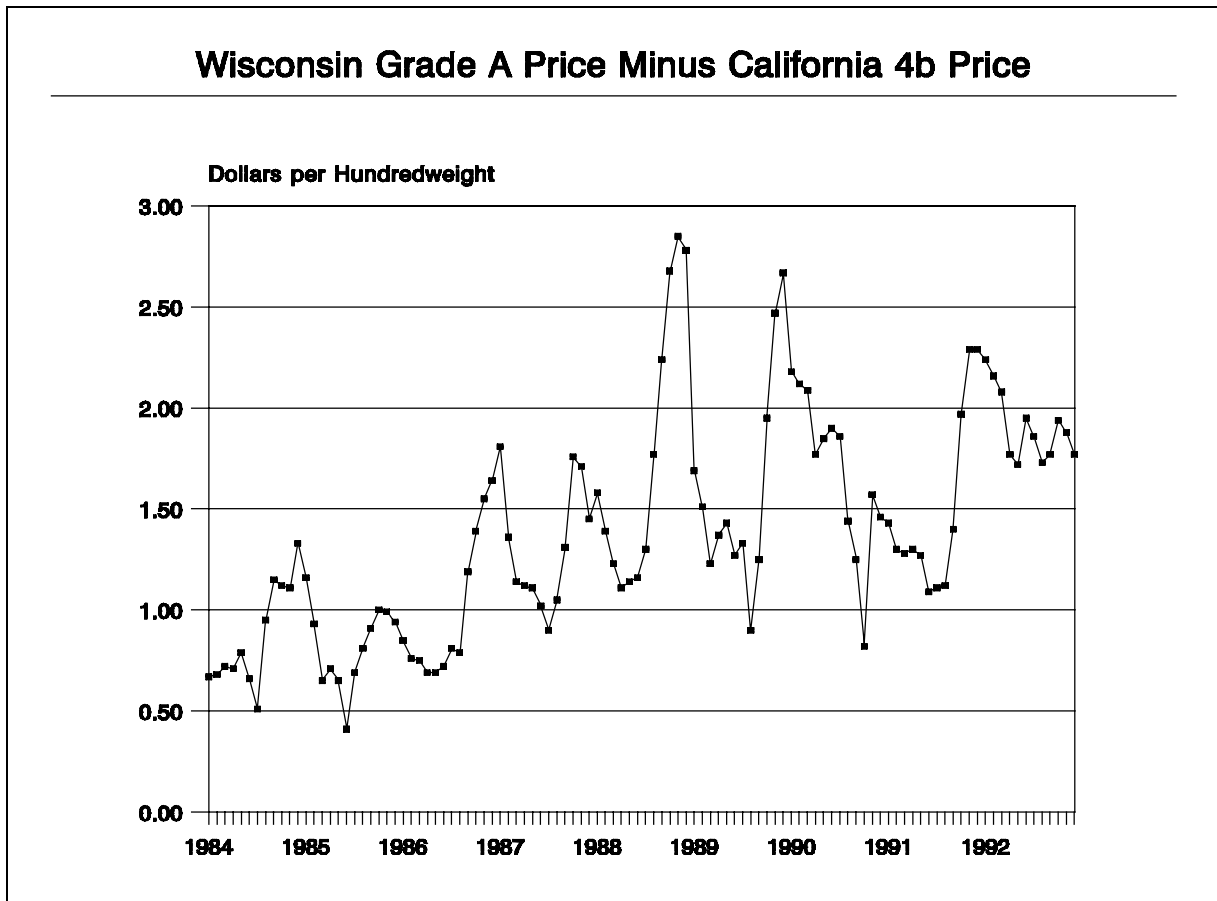


Figure 6

If the cost of milk to California cheesemakers were the M-W price, the 4b milk price would increase by about 75 cents per hundredweight. Forcing all manufacturing plants (butter/powder as well as cheese plants) to pay Class III-A and Class III prices has been predicted to raise producer prices by about \$.32 per hundredweight.<sup>9</sup>

This kind of producer price increase would seem to suggest a surge in California milk production. Indeed, a study commissioned by a California processor concluded that California milk production would increase so dramatically as to cause a substantial reduction in milk

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<sup>9</sup> This estimate was derived by a team of dairy experts in California operating as "The Section 102 Economic Impact Analysis Committee" and reported in an unpublished manuscript titled, *Section 102 Economic Impact Analysis* and dated February 10, 1994.



prices nationally.<sup>10</sup> If this happened, then the effects of implementing Section 102 would be exactly opposite those expected by the proponents of the law, who predicted a moderation of California milk production because of restricted plant profitability.

Underlying predictions of large milk production increases in response to reduced regulated make allowances is the assumption that milk plants, either in California or elsewhere, would be willing to absorb the increased supply. A plausible argument can be made that diminished profitability would sharply cut plant's demand for milk, leading to reduced milk production.

More likely than either of these extremes is no substantial change in plants' demand for milk, producer supply incentives, or net producer prices. USDA's amended regulatory impact analysis (December 1992) seems to be on the mark in noting that:

"...the impact of this regulation on farmers in the affected states cannot be determined with any degree of accuracy. One way or another, the costs of manufacturing need to be covered or adequate manufacturing capacity will be lost. Therefore, the most likely scenario is that Section 102 regulations will have essentially no impact on dairy farm income in the affected States."

Key in USDA's conclusion about the effects of Section 102 is the exemption offered dairy cooperatives in the proposed rules. Members cannot file complaints against their cooperative or their cooperative's customers. Therefore, it would seem that cooperatives would not be affected by implementation of Section 102 rules. Their revenue from cheese sales would not be changed by implementation, nor would their manufacturing costs. Hence, net revenue available for distribution to members would be the same. Even if a cooperative elected to comply by paying higher minimum prices, static net revenue would mean that cooperative patronage refunds would have to be reduced or assessments increased to offset the higher pay prices.

Currently, cooperatives account for about 17 percent of California cheese production. However, cooperatives account for most of the milk supplied to proprietary cheese plants. Consequently, most cheese milk is exempt from Section 102 either directly or indirectly.

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<sup>10</sup> The unpublished private consultant study predicted a 9 cent per hundredweight decline in milk prices outside of California. The study used an assumption provided by the California Department of Food and Agriculture that the average milk price in California would be elevated by \$.58 per hundredweight with implementation of Section 102. All plants, cooperative and proprietary, were apparently assumed to pay the higher Class 4a and 4b prices despite the cooperative exemption in the Section 102 rules. Plants were assumed to accept all additional milk produced despite lower margins. And Class 1, 2, and 3 prices were assumed to increase to maintain alignment with Class 4 prices. All of these assumptions are highly questionable, leading to equally questionable conclusions.

Implementation of Section 102 would impact proprietary plants who maintain their own producer base. It would seem logical that these plants would quickly switch to procuring milk through diversions from cooperatives to avoid Section 102 sanctions. Even if they wished to maintain their own producers, these plants could exploit the cooperative exemption by restructuring as cooperatives or quasi-cooperatives. They might also switch from buying milk to selling processing services to dairy farmers and buying cheese; that is, the plant would provide custom manufacturing of cheese without taking legal title to the milk used to make the cheese.

If proprietary cheese plants restructure as cooperatives, engage in custom processing, or procure their milk from cooperatives, then implementation of Section 102 would have little or no long-term impact on producer milk prices in California. In the short run, there would probably be some price enhancement as restructuring plants were temporarily obligated to pay higher prices for manufacturing milk. But long-term effects would be minimal.

If cooperatives were not exempt from the proposed rules, then the impact of Section 102 would likely be somewhat larger. To the extent that the current California make allowances exceed market-related processing margins, plant margins would be reduced by the excess. But, as the USDA analysis notes, manufacturing costs must be covered. If cooperative cheese plants could not cover their costs by paying the M-W price, then they would assess producers, reduce patronage refunds, or impose other charges to make up the difference. If proprietary plants could not cover their costs if forced to pay the M-W price, then they would either go out of business or seek arrangements with cooperatives to procure their milk. Hence, net returns to dairy farmers would only be increased by the amount of excess profitability that is associated with the current make allowances. Unfortunately, there is no way to measure this amount before the fact.

### ***Summary and Conclusions***

California sets prices for milk used to make cheese well below the minimum prices faced by cheese plants in other states. The regulated prices are even further below what Upper Midwest cheese plants pay for Grade A milk. This has created a situation where Upper Midwest markets are being lost to California and where Midwest-based cheese companies are being induced to relocate in order to take advantage of low raw product costs.

Section 102 was passed in an attempt to force the State of California to conform with national pricing standards. Current proposed rules would obligate cheese manufacturers to pay no less than the M-W price for milk, which is the minimum price for milk used in cheesemaking under federal milk marketing orders. Enforcement would be by producers filing complaints against their milk buyers. However, the proposed rules exempt cooperatives by prohibiting cooperative members from filing complaints against their cooperative. Members are also prohibited from filing complaints against a customer of their cooperative,

meaning that milk diverted by a cooperative to a proprietary cheese plant is exempt. While only 17 percent of California cheese is manufactured by cooperatives, cooperatives supply most of the milk used by proprietary cheese plants. Consequently, most California cheese milk would be included in the cooperative exemption.

In light of the limited effect of implementing Section 102 proposed rules, the strong and nearly unanimous resistance to implementation by California dairy interests is surprising. The State of California is not obligated to change its pricing system or enforce Section 102 compliance. Yet the state has filed suit to enjoin implementation. Cooperatives are exempt from implementation rules, and could benefit as the few proprietary firms who currently maintain their own producers were forced to switch to procurement of milk through cooperative diversions. Yet cooperatives are unanimously opposed to implementation. Cooperative members would, at worst, be no better off with implementation. Direct shippers to proprietary plants would gain in the short run until their plants restructured or switched to procurement through cooperatives. There could also be some longer-term producer price gains if cooperatives voluntarily elected to conform with the proposed rules or if the cooperative exemption were removed. Yet there has been no apparent support of Section 102 by California dairy farmers.

The unified opposition to Section 102 from California dairy interests would seem to be grounded in matters of states' rights. Section 102 is interpreted as improper federal intervention into California's right to set milk prices independent of prices set elsewhere. While this position may have philosophical appeal, it ignores the fact that California is the number 1 dairy state; milk pricing rules that are inconsistent with those applying to other states have profound effects beyond California's borders.

Finally, it must be emphasized that California's low 4b prices are only part of the competitive problem facing Wisconsin cheesemakers. Even if California cheese plants were obligated to pay the M-W price, Wisconsin plants would pay about \$1.00 per hundredweight more. This large Grade A premium is associated with intense competition for a declining milk supply and will continue until cheese processing capacity is in line with the supply of milk for cheese.