

BEFORE THE  
UNITED STATES DEPARTMENT OF AGRICULTURE  
WASHINGTON, D.C.

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NATIONAL HEARING TO CONSIDER )  
POSSIBLE CHANGES IN THE FEDERAL )  
MILK MARKETING ORDER PROGRAM )  
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COMMENTS OF THE DEPARTMENT OF JUSTICE

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By a notice dated April 3, 1990, the United States Department of Agriculture ("USDA") announced that it would hold a national hearing to consider possible changes in the Federal milk marketing order program, and invited interested parties to submit proposals for possible inclusion in a hearing notice. 55 Fed. Reg. 12,369 (1990). The Department of Justice ("Department" or "DOJ") welcomes this initiative of the USDA, and hereby submits its proposals for the hearing. Since the Depression, when the marketing order program was imposed, there have been dramatic advances in the dairy industry coupled with mounting public criticism against the continued legitimacy of the program. It is time that the USDA consider seriously and thoroughly the means by which this crucial industry can, like virtually all vital industries, be freed from archaic and inefficient economic regulation. At a minimum, the USDA should consider certain changes in the current system as a first step towards a market oriented milk industry. In this latter regard, the hearings should focus on those areas of the current

government regulatory system that have most harmed consumers and impeded economic efficiency, and thus particularly require elimination or modification. They include: (1) the payment, included in the Class I differential, to reflect the higher sanitation standards required for Grade A milk ("Grade A differential"); (2) the distance differentials; and (3) the down allocation and compensatory payment provisions for reconstituted milk. The USDA should also evaluate what interim steps should be taken to provide for a smooth transition from the current regulatory scheme.

I.

Elimination of the Entire Federal Marketing Order Program

The USDA hearings should consider the complete elimination of the marketing order program. The order program was instituted in an environment vastly different from that existing today. In the 1930s, low-level technology made consumers dependent on local supplies, and farmers ("producers") were captive to local dairies ("handlers"). Also, natural seasonal variations in milk production caused severe fluctuations in price, and led occasionally to marketing disruptions and even outbreaks of violence. The marketing order program was primarily intended to improve the plight of the dairy farmer, maintain "orderly marketing conditions" to

assure the flow of milk and avoid unreasonable fluctuations in supplies and prices, 7 U.S.C. §602(4)(1980 & Supp. 1990), and assure an adequate and dependable supply of fluid grade milk, 7 U.S.C. §608c(18)(Supp. 1990). Today, bulk milk can be moved over long distances because of greatly improved transportation and storage. High quality fluid milk reconstituted from dry milk powder can also be made available for sale at points distant from dairy farms. The vastly different conditions affecting milk marketing render the marketing order program unnecessary to assure an orderly and efficient market with an adequate supply of fluid grade milk. Indeed, the program actually impedes the achievement of those goals. 1/

The marketing order system is no longer necessary to maintain orderly marketing conditions without undue fluctuations in price. Distant source milk is now a potential source of supply because bulk milk can be transported great distances. The dairy farmer no longer need rely on a few, local purchasers and can serve distant markets where milk may be needed. Dry milk powder also can be stored and shipped where needed and then reconstituted into fluid milk. Such

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1/ It has been estimated that removing the marketing order program would eliminate annual waste of between \$402 and \$1,031 million. McDowell, et al, Federal Milk Marketing Orders -- An Analysis of Alternative Policies 30 (USDA ERS, September 1988).

reconstituted milk could substitute for fresh fluid milk in the event of any temporary local shortage. This would both assure an adequate supply of fluid grade milk and likely constrain any unreasonable seasonal price fluctuations in an unregulated market. 2/

Neither is the marketing order program necessary to assure an adequate supply of fluid grade milk. Because bulk milk can be transported long distances, milk from low-cost production areas could be used to supply areas with high production costs or supplement supply in areas with temporary shortages. Reconstituted milk is also available to compete with fresh fluid milk and supplement supply in case of any local shortages. These conditions make it highly unlikely that removing the marketing order system would result in an inadequate fluid milk supply anywhere in the country.

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2/ Modest price fluctuations in an unregulated market are neither disruptive nor disorderly; rather, they are necessary and desirable. They signal producers and consumers to respond to changing circumstances, such as by increasing or decreasing production or purchases. Market efficiency is improved when these natural responses are allowed to operate in a free market. Indeed, price fluctuations exist even within the marketing order program. Producers receive the "blend price," a weighted average of the Class I price handlers pay for raw milk used for fluid products and the Class II and/or Class III prices paid for non-fluid uses. Because Class I price differentials are high, the blend price varies seasonally when the Class I utilization rate changes.

A recent report by the General Accounting Office ("GAO") supports the conclusion that the marketing order program is no longer necessary to assure a healthy dairy industry. United States General Accounting Office, Report to Congress: Milk Marketing Orders, Options for Change (March 1988) ("GAO Report"). The report found that "(t)he premises for milk pricing under federal orders are outdated" and recommended that the milk marketing order program be changed so that market forces play a greater role in determining milk prices. GAO Report at 2, 66. The GAO concluded that there is no longer a need to encourage and maintain a locally produced supply of milk because milk is produced in all regions of the country, and technologies are available to transfer it, either as fluid or in a form to be later reconstituted as fluid, should local shortages develop. GAO Report at 2-3. 3/

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3/ The Department reached similar conclusions in a comprehensive report on milk marketing prepared in 1977, United States Department of Justice, Milk Marketing, A Report of the U.S. Department of Justice To the Task Group on Antitrust Immunities (January 1977) ("DOJ Report"). The DOJ Report found that the marketing order system had been an inefficient means of raising dairy producer income, and was not necessary to assure an adequate supply of fluid grade milk or maintain orderly marketing conditions. See DOJ Report at 435-95.

## II.

### Changes to Particular Aspects of the Marketing Order Program

As a first step towards a market oriented milk industry, the USDA may wish to consider during the hearings certain changes in the current program. Three particular aspects of the program have most harmed consumers and impeded efficiency and thus warrant immediate attention: (1) the Grade A differential, which encourages an over-supply of Grade A milk, should be eliminated or significantly reduced; (2) distance differentials, which needlessly encourage local production in high cost markets distant from Eau Claire, Wisconsin, should be eliminated or greatly lowered; and (3) the down allocation and compensatory payment provisions as they relate to reconstituted milk, which prevent reconstituted milk from being offered in competition with fresh fluid milk, should be removed.

#### A. Grade A Differential

In each Federal market order, the price for milk used for fluid consumption (Class I milk) is derived by adding a differential to the price of milk for manufacturing uses (Class III milk). This is called the Class I differential and is specified in each order. The Class I differential includes a payment for the higher sanitation standards which must be used to produce Grade A milk, the only milk that can be used for

fluid consumption. 4/ The purpose of this "Grade A differential" is to encourage farmers to upgrade their facilities to meet the higher sanitation standards for fluid milk, yet the existing differential creates a larger supply of Grade A milk than is warranted by market conditions. Approximately half of the nation's raw milk is used in fluid form; thus, it appears that only this fifty percent of raw milk supply needs to be Grade A. However, because of the incentive, the vast majority of all milk now produced is Grade A. 5/

The USDA hearings should consider the extent to which the Grade A differential has encouraged an excess supply of Grade A milk and whether the excess serves any purpose. 6/ Such oversupply of Grade A milk does not appear necessary to assure consumers an adequate supply of fluid milk, especially if artificial regulatory barriers to the use of reconstituted

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4/ Grade B milk can be used only for manufactured products such as cheese or butter. Its price is unregulated and is the basis of the Class III prices in all orders. The Class I differential in each order also includes a distance differential that varies with the order's location.

5/ The GAO report stated that about 88 percent of all milk produced is Grade A. It also stated that the Grade A differential is \$1.04 per hundredweight, even through the additional cost of producing Grade A milk may be no more than about 15 cents. GAO Report at 24.

6/ The USDA stated in its notice that the appropriate Class I price differential for each Federal order was an issue to be addressed in the hearings. 55 Fed. Reg. 12,369 (1990).

milk to meet any temporary, local shortage are removed. Unless convincing evidence of the need for a Grade A differential is submitted at the hearing, USDA should eliminate it.

**B. Distance Differentials**

The Class I differential also includes a distance differential which increases the price of Class I milk as the distance from the basing point of Eau Claire, Wisconsin increases. <sup>7/</sup> The resulting higher Class I prices theoretically reflect transportation costs, and thus provide a greater incentive for increased local milk production in markets distant from Eau Claire.

When examining the appropriate Class I differential for each Federal order, the USDA should consider the extent to which eliminating or significantly reducing distance differentials would create a more efficient market for the production and sale of milk. The USDA should consider whether there remain any valid justifications for encouraging such local production in light of the current ability to transport bulk milk long distances, and, in the event of a shortage of

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<sup>7/</sup> Eau Claire, Wisconsin, located in the heart of the surplus milk-producing area of the Upper Midwest, has been used as the basing point for the marketing order program.

fresh fluid milk, to supplement supply with high quality reconstituted milk. The USDA should also investigate the extent to which the distance differentials, or any other provisions of the milk marketing order program, serve to artificially distort shipment patterns of bulk milk from efficient producing areas to relatively high cost areas.

C. Barriers to Reconstituted Milk

Finally, the USDA identified the pricing of reconstituted milk as an issue which merited concern. 55 Fed. Reg. 12,369 (1990). The USDA should examine whether the down allocation and compensatory payment provisions, as they apply to reconstituted milk, should be eliminated. §/ Currently, the marketing order provisions require a handler to pay Class I prices for the powdered milk it reconstitutes. This removes entirely the economic incentive to reconstitute milk. As long as a handler must pay the Class I price, it might as well use local fluid milk and avoid the added cost to transport the powder and reconstitute it into fluid. Without these provisions, dry milk powder could be produced in the most

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§/ Reconstituted milk products are "down-allocated" to the lowest class of milk. Handlers who reconstitute powder into fluid milk are then required to make a compensatory payment into the local order pool which amounts to the difference between the Class I and Class III prices.

efficient production areas of the country and then shipped where needed and reconstituted into fluid at its destination. This reconstituted milk could be made available to consumers in competition with processed fresh fluid milk. It could also be used to supplement supply in the event of a temporary local shortage of raw milk. The current regulations produce the anomalous result that a safe product that consumers should have the option of purchasing if they desire is kept off the market by government regulation.

### III.

#### Assurance of Adequate Transition to Deregulation

The dairy industry is vital to the nation, and the marketing order program is both longstanding and pervasive. Thus, in freeing this industry from archaic and inefficient regulation, USDA should take care to assure a transition to free market forces that is as smooth as possible. The GAO proposed as one option that the marketing order system be eliminated over time. GAO Report at 66-67. The USDA also may wish to consider first phasing out the Grade A and distance differentials, and then removing down allocation and compensatory payment provisions to make reconstituted milk competitive. The USDA hearings should thus consider these and other options to determine the appropriate interim steps to accomplish best the transition to a free and efficient dairy industry.

IV.

Conclusion

Conditions affecting milk marketing are vastly different than they were when the marketing order program was established. These changed conditions indicate that a pervasive regulatory scheme is no longer necessary to assure a healthy dairy industry with orderly market conditions and adequate supplies of fluid milk, particularly when that scheme imposes substantial costs to society. Thus, the USDA hearings should consider means by which this costly and unjustified system of regulation ultimately can be most effectively and smoothly eliminated.

Respectfully submitted

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