

Upper Midwest Order: Distant Pooling Hurts All Producers, Depooling Just Hurts Some

Madison—Distant pooling “has an unambiguous negative effect on producer pay prices” by reducing the Producer Price Differential (PPD) for all producers, while depooling allows some handlers to protect their producers from a negative PPD while making the negative PPD “even more negative for producers affiliated with handlers that cannot fully depool.”

That’s one of the conclusions of a new paper, “Federal Milk Marketing Order Pooling, Depooling, and Distant Pooling: Issues and Impacts,” by University of Wisconsin-Madison dairy economists Ed Jesse and Bob Cropp.

“Distant pooling is an economic issue. Depooling is an equity issue,” the economists wrote. They believe that both issues should be addressed through federal order amendments.

The Issue Of Distant Pooling

“Distant milk is pooled on the Upper Midwest order for one purpose: to take advantage of the Upper Midwest PPD, which is intended to compensate producers for legitimately servicing the fluid market,” Cropp and Jesse noted.

Because of the Upper Midwest order’s one-time touch base producer qualification provision and liberal non-pool diversion provisions, it can be economically advantageous for cooperatives and other plants located quite distant from the order marketing area to affiliate producers and their milk with the Upper Midwest order; that is, to pool milk on the order.

Substantial volumes of milk from Idaho have recently been pooled on the Upper Midwest order, Jesse and Cropp pointed out. Except for the required touch base shipments to an Upper Midwest pool plant, this pooled milk is used primarily by Idaho plants to make cheese in Idaho.

Milk sourced in Idaho accounted for 1.8 billion pounds of producer milk on the Upper Midwest order last year, 10.6 percent of total producer receipts. Pooled milk from Idaho exceeded the combined pooled milk from the states of Illinois, Iowa, Michigan, North Dakota and South Dakota, parts of which are within the Upper Midwest marketing area.

The effect of distant pooling is to reduce the value of the PPD in the receiving market, Jesse and Cropp explained. This occurs because the milk pool (the amount of milk eligible to share in the federal order money pool) is increased more than the money pool (the amount of money generated by applying minimum federal order class prices to the amount of milk used in each class within an order).

With more milk pooled and constant higher-valued Class I and Class II sales in the marketing area, the weighted average value of pooled milk decreases.

On average for 2003, the Upper Midwest monthly PPD was reduced by 25 cents per hundredweight by Idaho milk pooled on the order, according to an estimate by the order market administrator at the request of one of the groups of co-ops seeking a hearing on distant pooling.

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—Ed Jesse and Bob Cropp,
University of Wisconsin-Madison dairy economists

The Western order was terminated effective April 1, 2004, so Idaho cheese plants are no longer regulated by a federal order. This has raised the concern that even more Idaho milk will be pooled on the Upper Midwest order.

To evaluate the potential impact of more Idaho milk finding a home on the Upper Midwest order, the order administrator estimated what the PPD would have been if 50 percent of the Class III and Class IV producer milk pooled on the Western order last year would have been pooled on the Upper Midwest order.

These larger shipments would have reduced the Upper Midwest PPD from actual by an estimated five cents per hundred; that is, by five cents more than the reduction already associated with Idaho milk pooled on the Upper Midwest order.

The restriction that co-ops submitting proposals to date are asking for would prevent milk from outside the states included within the Upper Midwest marketing area from being diverted to non-pool plants outside the marketing area. While this would not prohibit the pooling of distant milk on the order, it would substantially weaken the incentive to do so because more milk would incur transportation costs, Jesse and Cropp explained.

Depooling Cause, Solutions

The difference in timing of the price announcements of Class I milk (and Class II skim milk), which are advanced prices, and Class III and IV prices, which are not announced until early in the month following the month to which they apply, gives rise to incentives to depool, Jesse and Cropp noted.

The Class III price for any month is announced six weeks after the Class I price. If the price of cheese increases rapidly between the announcement dates, then the

monthly Class III price can end up higher than the Class I price.

This "price inversion" reverses the normal obligation of pooled handlers to the producer settlement fund. Fluid processors draw from the fund and cheese plants are required to pay into the fund.

To avoid this payment, cheese plants depool.

Depooling is constrained in some orders by preventing repooling for a specified time after depooling. The proposal for the Upper Midwest hearing would limit pooled milk in any month to a specified percentage of pooled milk in the previous month, so if a plant depooled in one month, it could only partially repool in the subsequent months.

Regardless of how it is accomplished, restricting depooling deals with the symptom of a problem rather than the problem itself.

The problem is price inversion caused by the combination of volatile cheese prices and advanced Class I pricing, Jesse and Cropp explained.

Federal orders can't address volatile cheese prices, but "it may be time to seriously consider eliminating advanced pricing for fluid milk," Jesse and Cropp observed.

This would raise strong objections from fluid milk processors, who would legitimately argue that eliminating advanced pricing would make it difficult for them to establish list prices for retailers and other outlets and lead to unpredictable and unstable operating margins.

However, there are ways to deal with this instability, Jesse and Cropp noted. For example, if Class I prices were tied to monthly instead of advanced Class III prices, fluid processors could engage in hedging to lock in minimum prices.

This would require elimination of the "higher of" Class I pricing concept; Class I prices would need to be linked exclusively to the Class III price. In the judgment of Jesse and Cropp, eliminating the "higher of" mover has substantial benefits besides those associated with preventing price inversion.

Over-order bargaining co-ops could also serve to help stabilize processor milk costs in the absence of advanced Class I pricing. For example, over-order premiums could be adjusted to accommodate large month-to-month changes in federal order Class I prices.

Depooling results in non-uniform producer pay prices, but restricting depooling "could conceivably make this problem even worse if it encouraged regulated handlers to permanently disaffiliate from the order," Jesse and Cropp noted.

In that case, the reserve supply of fluid milk would shrink and shipping requirements would need to be increased for remaining pooled supply plants and dairy cooperatives. •