UNITED STATES DEPARTMENT OF AGRICULTURE
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DEVELOPMENT OF COMPENSATORY PAYMENTS IN FLUID MILK MARKETS

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Many of the Federal milk marketing orders contain provisions requiring payments on unregulated milk, or compensatory payments, as they have come to be known. The nature of such payments is generally understood. They are payments which regulated milk distributors must make on the fluid milk they buy from unregulated plants.

The reasons for such payments are not well understood. It is appropriate, therefore, that a conference such as this should give consideration to the basis for compensatory payments and to the problems they involve.

A better understanding of compensatory payments should do two important things. It should help the industry people affected to adapt their operations with a full knowledge of the purposes and effects of the provision. It should contribute also to improvements in the order provisions themselves, in line with the standards of orderly marketing and adequate milk supply as contained in the Marketing Agreement Act.

In recent months, a great deal of attention has been focused on compensatory payments. This is the result in large measure of changes in the pattern of milk marketing which have developed rapidly over the past few years. These changes have been of such a nature that they have increased the need for and the use of compensatory payments.

Since our experience with such payments is as yet rather limited, it is likely that they can be adjusted or improved as time passes. Such adjustments may be needed to facilitate the efficient and orderly movement of milk from producers to consumers. It may be that a different and better method of regulation may be devised in the future which will accomplish the purpose of compensatory payments and which will be more widely understood by those affected.

Some questions have been raised concerning the use of compensatory payments under Federal orders. Opposition to such payments has been based largely, I believe, on a misunderstanding of both their purpose and their overall effect. It has been asserted that these payments are penalties, special excise taxes on milk from outside sources, or trade barriers by which a given milk market may be reserved for a particular group of producers. An easy, but incorrect, explanation of the payments is that they are a means whereby the fluid milk price may be protected at an abnormally high level in that they discourage importation of outside milk through the assessment of an additional payment on such milk.

Compensatory payments unquestionably do discourage some transactions which might otherwise be encouraged in markets where classified pricing programs are in operation. Plant operators who have offered bulk milk for sale in a regulated market may have been refused sale in some instances at the going price for such milk because compensatory payments would be required on such milk. These people may have difficulty in believing that there is not an element of trade barrier in such payments. Compensatory payments as used under the order program are barriers, however, only to the extent, and no more, than the classified pricing system itself is a barrier to free trade in market milk.

Classified pricing systems for milk are well understood and widely accepted in older milksheds. They may not be as fully accepted and certainly are not as well understood in some of the newer areas of Grade A milk supply.

Classified pricing systems are now used almost universally in the larger milk markets of the country. They were developed, for the most part, at a time when milksheds were more or less confined to those farms which were under rigid inspection of the health authority having jurisdiction over the local market. Such inspection was necessary because of the inadequacy of other methods of assuring the safety of the milk supply. Under such systems, the classified pricing program was subject to far less pressure than it is today. Even so, these classification plans developed, as a rule, only after years of turbulence and, in some instances, chaos in the market.

The two basic conditions which brought about classified pricing systems were the inability to adjust milk production so that it just equalled demand on a day-to-day basis, and the need for a premium over ungraded milk prices to sustain production of the quality milk required for fluid use. The reasons for the existence of excess or surplus milk above Class I needs in a fluid milk market, such as perishability of the product, fluctuations in production and consumption, and so on, are well known to this group.

The need for some premium over ungraded milk prices to obtain Grade A production has been established on the basis of many years' experience throughout the country. If the production of satisfactory milk to be used for fluid consumption is to be maintained, the price received for such milk must be somewhat above the rate of return obtained from milk used in manufacture. This extra money can come only from the milk actually used for fluid consumption. As a matter of fact, this is the place it should come from, since consumers of fluid milk should pay the costs necessary to give the assurance of supplies of such milk as they demand. Milk disposed of as excess cannot yield an extra return. If it is to be marketed at all, it must move into manufactured products. If it is run down the drain, as is now the case in isolated instances, it would yield no return at all, and the price for fluid milk would have to be raised that much higher to maintain the necessary levels of milk production.

This excess milk is an essential part of the market supply, however, and it must be disposed of in some manner. In an unregulated or unorganized market, the owner of such milk will normally try to sell it to his best financial advantage. Disposition of a portion of milk to fluid-milk outlets, and the remainder to manufactured-product outlets, will naturally yield a blended return. How much this return will be above the manufacturing value depends upon the proportion of milk sold for fluid uses.

In such a market, there is no limitation on how Grade A milk may be marketed. The distributor who can sell the largest share of his milk in the fluid market will naturally be in the best position because his net returns from the sale of milk will be above that of his competitors. Since milk dealers are in business to obtain the best possible profit, they would naturally make an effort to gain the largest possible share of the fluid market. Such competition may well lead to concessions in the fluid milk price, first by one dealer and then by another. The only floor or bottom to this price cutting may be the value of the milk for manufacture. This price-cutting force tends to be strongest, and the potential losses or gains to dealers greatest, during the spring months or other periods of flush production.

Individual dealers are not in a position to hold the line against such price cutting. No distributor could long afford to pay a premium price for the milk he used for fluid sales and sell in competition with others who are buying such milk at manufacturing prices.

Producers in the older market supply areas have seen this process develop. In some instances, they themselves suffered most of the consequences. Handlers who were unwilling to receive enough reserve milk to sustain their own operations on a year-round basis sometimes attempted to solve their problems by cutting off producers. In this way, a handler could pay producers at a blend price and sell all his milk for Class I use. Producers cut off in this process were ordinarily forced to sell to manufacturing plants or make their milk available to other fluid distributors at reduced prices.

The end of such price cutting among producers, like that among handlers, may well be the manufactured milk price. In both instances, the competitive process destroys any price differential for Grade A milk production. Without a stable and dependable incentive for production of fluid milk supplies, the position of distributors and consumers, as well as the position of producers, would be seriously jeopardized.

As a result of the experiences under such competitive conditions, producers supplying most large markets realized that it was in their best interest, as well as the interest of distributors and the market as a whole, to institute a classified price plan for the entire market. All distributors would thereby pay a full Class I price for any milk for fluid use, and each producer would be paid for his proportionate share of the excess milk of his distributor or of the market.

In a large number of instances it was necessary to resort to some governmental authority to require that each dealer pay the price for fluid milk which was necessary to stimulate adequate production of Grade A milk over a period of time. The competitive position of all dealers who abided by a classified pricing program would be assured under this program.

By and large, classified pricing has proved satisfactory to producers and to the markets where they have been used. There is comparatively little indication that individual producers supplying regulated markets at the present time attempt to gain a disproportionate share of the Class I milk sales. In my judgment, this may be attributed to a general realization that classified pricing is essential, and to make it work, each individual must accept a lower return on a fair share of his milk.

Whereas the problems of supplies and prices in the earlier days of the order program were confined largely to the local milkshed area, the problems are now much more widespread and difficult. Improved trucks and roads, coupled with the increased interchangeability of inspected milk and other factors, have greatly extended the potential supply and distribution area. The first classified pricing programs had the problem of controlling a market in terms of its nearby and locally inspected milk. The primary purpose of these programs was to keep the market's own excess supplies from entering into competition on the fluid milk market and destroying the Class I price structure.

With the increased movability of milk and its interchangeability, it is now necessary to take into consideration the inter-relationship of supplies and distribution in not only the market itself, but in other markets, some of them far distant.

Obviously, it would be impossible to protect the Class I utilization of a market from demoralization by use of its own excess or reserve milk and, at the same time, allow such milk to be sold without regulation from another market. It is not difficult to visualize the quick end which would be brought to classified pricing programs in neighboring cities if they were able to unload their surpluses on each others' Class I markets without limitation of any kind.

Compensatory payments have no other purpose under the order program than to insure the effectiveness of a classified pricing program. Congress has authorized milk to be classified and priced in accordance with its utilization. This cannot be done on a selective basis. Part of the milk entering a market cannot continue to be regulated and subject to classified prices if another part of it can enter freely, without price fixing of any kind, and displace priced milk whenever it is advantageous to do so. Some provision to prevent this seems to be not only incidental but absolutely necessary to permit a classified pricing program to be effective.

Under the order program, the regular sources of milk for a market are brought under regulation and pricing. The orders do not say who or where these sources shall be. Any plant or any producer may qualify as a regular source, as far as the orders are concerned, by making milk available in accordance with the terms of the order.

In order for the milk to be considered available, it must meet the standards of the appropriate health department. Also, producers delivering their milk to plants located at a distance from the market must expect less for their milk because of transportation costs. These two limitations are not imposed by the order program but must be recognized in drafting order regulations. Aside from these provisions, however, orders should provide equal treatment for any plant or producer, regardless of location.

If it is agreed that a classified price plan is necessary, and that it should be maintained in a market by guarding against encroachments on the Class I market by its own excess milk or by that from other markets, then the next question to be answered is whether compensatory payments are the best means for assuring such protection. Perhaps the best way to approach this question is to consider the alternatives. The first alternative which might be considered would be to prohibit the sale of any milk except that from regular sources priced under the order. The act does not grant authority, however, for such a limitation. Nor would a regulation of this kind be desirable. If the milk is acceptable to the health authorities of a market, the order program should not prevent its sale.

A second alternative would be to fix milk prices in <u>all</u> plants which supply milk to either consumers or distributors in the regulated marketing area. This may have disadvantages both in the plants supplying the milk and to the market. It would greatly expand regulation, since any plant which supplied any quantity of milk to the market would be brought fully under the order. The market might have difficulty obtaining supplemental milk if plants which could otherwise furnish needed supplemental milk preferred not to come under regulation. Such a method would also open up a marketwide pool to any plants or producers that found it advantageous to share in the Class I sales of the market on an opportunity basis. It would be necessary only to supply a token quantity of milk to plants or consumers in the market. Under the present provisions of the act, all plants whose milk prices are fixed must be included in the marketwide pool. Unlimited participation in the marketwide pool would permit surpluses from other markets to be shifted to the regulated market. Such widespread distribution of pool funds to persons not associated with the market would divert the returns from the fluid milk sales away from their purpose of encouraging the production of a dependable supply of quality milk. Thus, the effectiveness of a marketwide pool in providing orderly marketing and adequate milk supplies would be destroyed. No program of regulation with a marketwide pool could be successful under these conditions.

If neither of these alternatives can be used, then it is clear that there may be some unpriced or unregulated milk available for sale in the market. If this milk is available to distributors at a cost less than that for Class I milk priced under the order, then there will be an incentive to buy the unregulated milk. If any distributor buys such lower-cost milk, his competitors will be at a disadvantage if they do not do likewise. Such a situation would naturally threaten the stability of any classified price program and has, in the past, resulted in producers being cut off the market. This situation is identical, in fact, to that previously discussed, which necessitated the institution of compulsory classified pricing in the first place.

The method which has been adopted under the Federal order program to avoid such market instability is to require a payment on unregulated milk used for fluid distribution. There appears to be no suitable alternative method under the present authority of the act. The rate of payment should be one that will assure that regulated distributors may not secure unregulated milk at a cost advantage over regulated milk. If milk purchased from outside sources for fluid use costs handlers as much as milk purchased under the order, then the objective of compensatory payments has been achieved. It is not an objective of these payments to secure money to be distributed to producers under the order.

That, in a few words, represents, as I see it, the basis and justification for compensatory payments. It might be well, however, to address a few remarks at this point to some of the problems encountered in determining the rate of payments to be used.

I have said that the purpose of compensatory payments is to bring the cost of other-source, or unregulated, milk up to the cost of milk priced under the order. It has been suggested that this might be accomplished by having the market administrator determine the actual price paid for the unregulated milk and charge the distributor the difference between the cost of such milk and the Class I price. If a rate of payment could be determined on this basis which would bring the cost to a point where it equalled the cost of regulated milk, that would represent a satisfactory solution to the problem.

It is not feasible, generally speaking, however, to determine the cost of the unregulated milk. The cost of such milk presumably would be determined on the basis of billing prices and payments. In the case of a firm which owns plants under regulation and unregulated plants, however, the billing price between such plants might be readily adjusted to avoid any payment. The level of the billing price would have no effect upon the profit of the overall operation. There are few, if any, regulated markets which do not have one or more milk distributors with outside affiliations.

In the case of unaffiliated firms, billing prices for unregulated milk might be adjusted for the mutual benefit of both parties through tie-in sales or other arrangements. Experience has proved these practices are extremely difficult, if not impossible, to regulate.

Even though it were possible to determine the actual cost of unregulated milk, it would still be next to impossible to know what rate of payment should be used to make the cost of unregulated milk equal to that of regulated milk. Milk traded between regulated dealers normally yields a handling charge to the seller. Unless regulated milk is to be at a disadvantage, it will be necessary to bring the cost of the unregulated milk up to a level above the Class I price to reflect a handling charge. What this charge should be is difficult to say. It would vary considerably according to the circumstances involved.

As an alternative, the rate of compensatory payments under most orders is based on the difference between the general level of prices at which it appears evident that unregulated milk may be available and the Class I price. Whether or not these rates are appropriate is a complicated and difficult question in itself. Conditions relative to the prices of such milk vary from time to time. No doubt order provisions can be drafted after there has been more experience with these payments which will take such variations more completely into account. Whatever the general price level of this milk, it must be assumed that dealers will buy that milk which costs them the least. During periods when substantial quantities of Grade A milk are being manufactured, it would seem logical that the cost of unregulated milk would be the ungraded milk price plus a handling charge plus freight.

Removal of compensatory payments from the orders, would permit some sales of milk which would be to the temporary advantage of the people involved in the transaction. Such advantage would be comparable, however, to that gained by individuals within the market who might obtain a Class I outlet for their surplus milk. Such advantage would, in the end, result in a breakdown of classified prices just as they have broken down in many unregulated or unorganized markets. Generally speaking, the type of transaction to which compensatory payments apply would not take place in the absence of a classified pricing program. A Class I market which is insured against competition from excess or reserve milk appears to be an attractive outlet to anyone compelled to dispose of Grade A milk for manufacturing purposes. In the absence of an insured classified pricing program, however, the market's own surplus probably would already have made the Class I outlet unattractive.

I should like to repeat at this point that compensatory payments have no other purpose than to insure that a classified pricing program will protect a market not only from its own surplus but from the surplus of other markets. Compensatory payments do not prevent milk plants from becoming associated with a regulated market. They do not determine which milk will be priced and pooled with the market. They do not provide that a plant may or may not qualify for the sale of Class I milk into a regulated market. They merely provide that if a plant chooses not to become associated with the market it may not sell its milk into the market in such a way as to destroy the effectiveness of the classified pricing program in the market.

Neither are compensatory payments a feature nor an adjunct of high Class I prices. Classified pricing programs are as common in large markets of the midwestern dairy areas as in the eastern or southern sections of the country. In order for a classified pricing program to succeed in either area, it is necessary to insure that all distributors must pay the minimum Class I price for milk sold for fluid consumption.

The protection for the Class I price to which I have referred is not intended to represent an assurance of a price which is more than adequate to bring forth the necessary dependable supplies of quality milk, including adequate reserves. Class I prices in excess of this level should not be protected.

In no case are compensatory payments, by themselves, tools by which such protection can be accomplished. If Class I prices are too high under the order program, they bear the seeds of their own destruction. Such prices bring additional milk to the market. This comes about through increased rates of production by producers and through the addition of new plants which may be attracted to the market. These additional supplies reduce blend prices and call for a reduction in Class I prices under the standards of the Agricultural Marketing Agreement Act. Most of the orders now contain provisions which bring about a Class I price reduction automatically when supplies increase in relation to demand.

Compensatory payments do not interfere with these processes which bring about reductions in prices. They do not interfere with the association of a milk plant with an order market. They provide that if the plant does not associate itself with the market, it may not sell its milk to regulated handlers on an opportunity basis which would make it impossible to maintain the Class I price level necessary to assure adequate milk supplies and insure a dependable system of distribution.