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Federal Order Milk Pricing and the Economic
Viability of the Upper Midwest Dairy Industry

by

Edward V. Jesse and Robert A. Cropp

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FEDERAL ORDER MILK PRICING AND THE ECONOMIC VIABILITY OF THE UPPER MIDWEST DAIRY INDUSTRY

Ed Jesse and Bob Cropp¹

Introduction

Pronounced regional shifts in the location of U.S. dairying have occurred over the last two decades. The Northeast and the Upper Midwest states of Minnesota and Wisconsin dominated dairying during much of the post World War II period. These regions were the primary source of manufactured dairy products, with milk production in much of the rest of the U.S. limited to supplying local fluid and soft product needs. The market share of the Northeast began to decline in the 1970s, due in large part to increasing urbanization in some dairy areas in that region. Later, large gains in milk production in the Western and Southwestern U.S. caused the market share of the Upper Midwest region to fall, even though production continued to increase. But by the mid-1980s, the absolute level of milk production in the Upper Midwest began to decline. Combined with continued expansion in the West, this accelerated the region's loss in share of the U.S. milk market (Figure 1).

For Minnesota and Wisconsin, declining milk production is a serious economic threat. Dairy and other livestock represents the best use of much of the states' land. Dairying is the major agricultural enterprise and contributes in a substantial way to the states' economies, both directly and through related service and value added activities. Less milk means less income, fewer jobs, and more unutilized manufacturing capacity.

In both states, government-university-private sector consortia have recognized the seriousness of the problem by initiating special programs to revitalize their dairy sectors: The Minnesota Dairy Initiative and the Wisconsin Dairy 2020 Project. These programs have addressed farm level constraints to more profitable dairy farming, encouraging the adoption of lower-cost production systems and management strategies and supporting state legislative changes to improve the economic climate for dairying.

¹ Professors and Extension Dairy Marketing Specialists, Department of Agricultural Economics, University of Wisconsin-Madison.

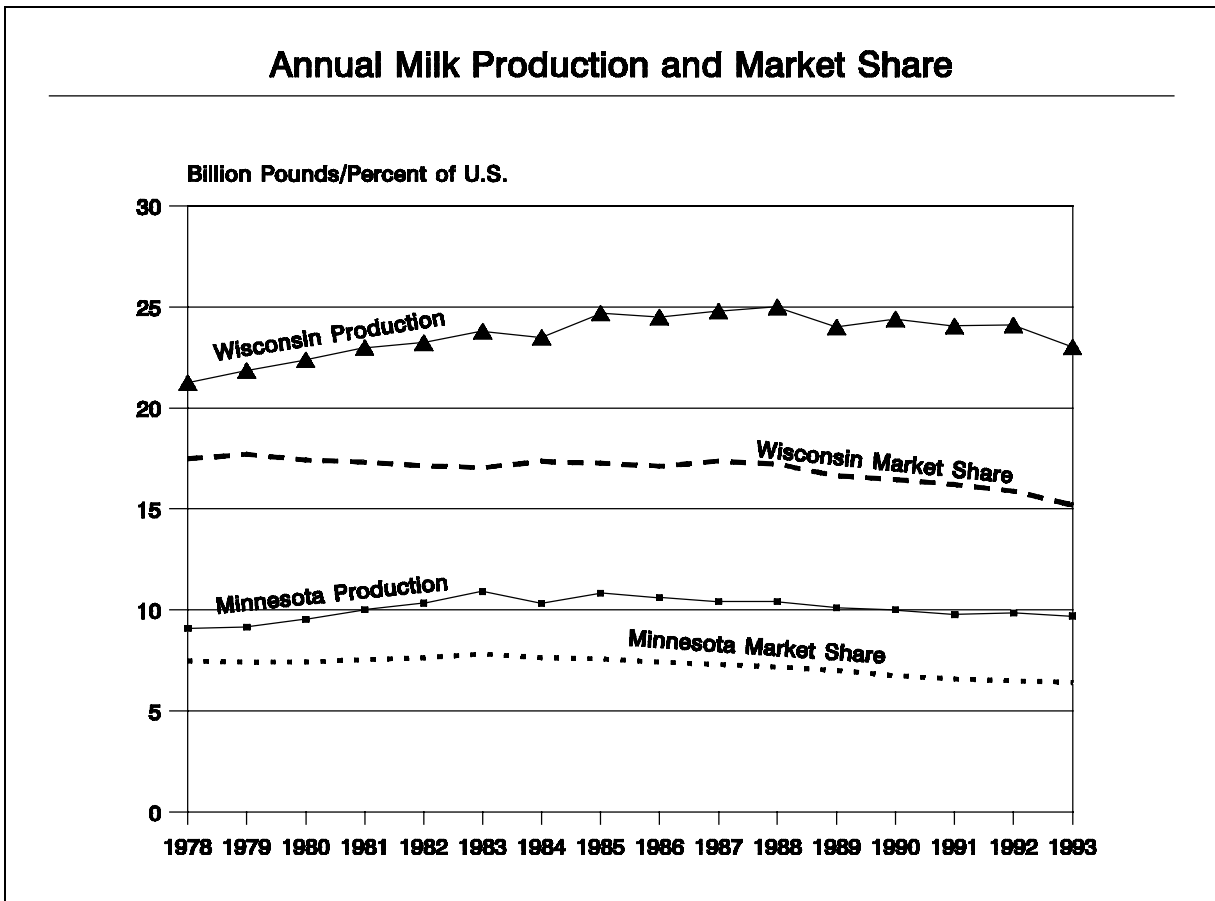


Figure 1

These efforts are appropriately-focused. Dairy farms in Minnesota and Wisconsin are, on average, much smaller than their counterparts in rapidly-growing dairy regions and have generally adopted yield-increasing production and management practices more slowly. Milk production per cow has fallen below the national average. There has been limited new investment, leading to wide-spread incidence of obsolete and outdated facilities. The region is not achieving full potential in milk production per cow. There has been excessive dependence on the historical model of dairy diversification -- combining dairy feed production with milk production -- with inadequate attention to the advantages of specialization. Entry into dairy farming has most often involved new farmers assuming the obsolete assets of retiring farmers, meaning that beginners often start off with a major obstacle to sustained profitability.

Despite its apparent loss of regional competitiveness and resulting retrenchment, the region possesses many inherent attributes associated with profitable and sustainable dairying. The states are well positioned in terms of product mix. Most of the region's milk is used to make cheese, which is the only major dairy product that has experienced large, sustained growth in per capita consumption in recent years. Minnesota and Wisconsin dairy products enjoy an excellent

consumer image that can be exploited through appropriate promotion and product differentiation. The region is favorably located relative to major eastern and midwestern population centers. There is an excellent, extensive dairy supply and service infrastructure in place. Feed costs are low because of relatively inexpensive land and good forage and grain producing capacity. There is an ample supply of good water. Good markets exist for cull dairy cattle.

In light of these important advantages, what caused Minnesota and Wisconsin to lose their competitive dairy edge? The simple answer is that it is less profitable to produce milk in the Upper Midwest than it is in those regions where milk production is expanding. Low profits translate to the limited new investment, accelerated industry exit and the general malaise that is often observed in the region.

Why are dairy profits low? The per-unit cost side of the dairy profit equation is affected by the farm-level characteristics noted above. Certainly, much can be done to reduce costs, and the dairy initiatives in Minnesota and Wisconsin are helping in that regard. Recent experience shows that new, larger dairy operations are very cost-competitive and profitable at current milk prices. However, cost-reducing strategies that would increase profitability require capital investments that often cannot be financed because of inadequate profitability on most existing operations and an overly cautious farm lending community.

Moreover, costs of milk production in the region are not unusually high when compared to other regions (Table 1). In fact, cash costs in the Upper Midwest rank the lowest among seven regions defined by USDA in their regional dairy cost of production estimates. Economic costs, which include investment costs and a return to unpaid family labor, compare unfavorably with the Pacific region, but are competitive with the Southern Plains and below economic costs experienced in the other regions. However, because of relatively low milk prices, returns over economic costs have averaged substantially less than most other regions. Milk prices are the lowest for the Pacific region, but lower economic costs still nets a higher return over economic costs than for the Upper Midwest.

While milk prices in Minnesota and Wisconsin are *relatively* low in comparison to most other regions of the United States, they are not the lowest. Figure 2 shows average state milk prices for 1992. Several states, all of them in the Western or Midwestern United States, had average milk prices lower than Minnesota and Wisconsin. Eight Western states (California, Idaho, New Mexico, Utah, Nevada, Wyoming, Washington, and Oregon) experienced a production-weighted average milk price in 1992 of \$11.96 per hundredweight, which compares to \$12.85 for Minnesota and \$13.17 for Wisconsin. In total, these states increased milk production by 21.7 percent between 1988 and 1992. Meanwhile, Minnesota milk production fell by 5.4 percent and Wisconsin's by 3.6 percent.

Table 1. Regional Milk Production Costs and Receipts, Average, 1987-91

	Gross Receipts	Cash Costs	Economic Costs	Return over Cash Costs	Return over Econ. Costs
	Dollars per Hundredweight				
Pacific	12.86	10.34	11.48	2.51	1.38
Upper Midwest	14.20	10.13	14.34	4.08	-0.14
Corn Belt	14.30	10.50	15.78	3.80	-1.47
Northeast	14.71	10.22	14.59	4.49	0.12
Appalachia	14.94	10.78	14.77	4.16	0.17
So. Plains	15.08	11.58	13.65	3.50	1.43
Southeast	16.59	12.66	14.44	3.93	2.15

Source: U.S. Department of Agriculture, Economic Research Service, *Economic Indicators of the Farm Sector: Costs of Production--Major Fields Crops & Livestock and Dairy, 1991*, ECIFS 11-3, February 1994.

These are disturbing numbers for the Upper Midwest: Western states are expanding milk production rapidly in spite of milk prices that are lower than in Minnesota and Wisconsin. There is a clear and pressing need to control costs in order to compete with these low-cost regions. But at the same time, prices in some other expanding dairy regions are higher than experienced in the Upper Midwest despite similar or lower milk production costs. This has had a serious negative impact on the value of milk used for cheese, which accounts for the large majority of milk utilization in Minnesota and Wisconsin.

Specifically, federal milk pricing rules have resulted in a situation where the volume of milk going to cheese production is being increased by subsidies created by federal milk marketing orders. These subsidies are the product of (a) single basing point pricing for fluid milk and (b) the use of Grade B milk prices in Minnesota and Wisconsin to establish minimum Grade A milk prices in other areas. The result of these subsidies is prices for milk used for cheese that are lower than would otherwise exist.

State dairy initiatives cannot deal with this problem. It is national in scope. Yet it is a major factor contributing to unprofitable dairying in Minnesota and Wisconsin. Federal order pricing rules have also reduced the price competitiveness of Minnesota and Wisconsin cheesemakers in marketing cheese nationally, threatening the states' dairy manufacturing sector. Unless regional pricing distortions are corrected, Minnesota and Wisconsin will continue to experience abnormal competitive pressures and diminished viability of dairy farming and dairy manufacturing in the region.

All-Milk Prices by State, 1992

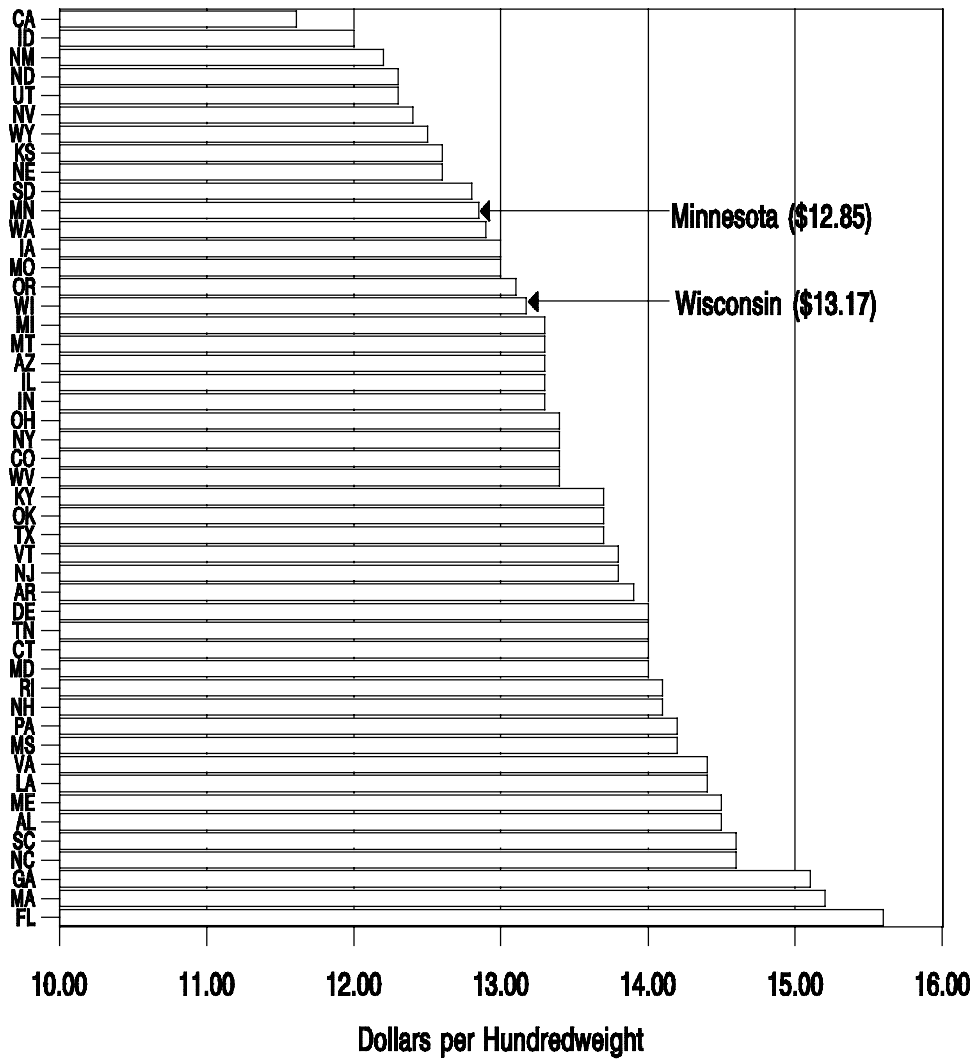


Figure 2

Federal Milk Marketing Orders

Federal milk marketing orders regulate dairy plants (handlers) that market Grade A milk. Grade A milk is produced under monitored dairy farm sanitary conditions that qualify the milk for use in fluid dairy products. While Grade A milk is *eligible* for use in fluid products, most is used to produce manufactured products. Grade B milk, which is not regulated by federal orders, can only be used to make certain manufactured dairy products. Over 90 percent of U.S. milk is Grade A. In Wisconsin and Minnesota, about 80 percent of the milk produced is Grade A. The two states together account for about half of all Grade B milk produced in the U.S.

There are 40 federal milk orders covering most of the United States. The major exception is the state of California. California has its own state milk pricing program, which operates much like federal orders.² Each order covers a specific geographical region, known as a marketing area, corresponding to a common distribution area for fluid milk.

Milk orders use *classified pricing* and *pooling* to establish minimum prices to be paid by milk plants and to dairy farmers. Classified pricing means that different prices apply to milk depending on how it is used. The orders define three classes of milk: Class I is milk used for beverage or fluid purposes. Class II is milk used for designated perishable dairy products like cottage cheese, yoghurt, and ice cream. Class III is milk used for non-perishable, or "hard" manufactured products like butter and cheese.

Under milk order regulations, minimum class prices are announced each month. Regulated handlers cannot pay less than the announced prices.³ The minimum class prices are set according to formulas that tie the class prices to the Minnesota-Wisconsin price series (M-W price).

The M-W price is the average monthly pay price for Grade B milk from a survey of plants in Minnesota and Wisconsin. Since the marketing of Grade B milk is not regulated by federal orders, the M-W price is judged to be a competitively-determined pay price for Grade B milk in Minnesota and Wisconsin. Nearly all Grade B milk in Minnesota and Wisconsin is used to make cheese, which is also a Class III product under federal orders. There is no price difference between cheese made with Grade B milk and Grade A milk.

² The California milk pricing system sets the price for milk used to make cheese well below the price paid in Minnesota and Wisconsin by guaranteeing cheese plants a generous manufacturing margin, or "make allowance." California cheese plants have thereby been afforded an opportunity to gain substantial inroads into markets once served by Minnesota and Wisconsin. This serious problem is being challenged by federal legislation. It is not addressed here in order to focus on the more serious problems created by federal milk pricing rules. For an expanded discussion of the California make allowance issue, see Marketing and Policy Briefing Paper No. 46, "Section 102: The California Make Allowance Issue."

³ There is an exception to the minimum price rule for dairy cooperatives. Cooperatives are viewed as extensions of the businesses of their farmer members for purposes of federal order administration. This effectively exempts cooperatives from paying minimum prices.

The class prices are established in reference to the M-W price. The Class I price is the M-W price for the second preceding month plus a *Class I differential*. Class I differentials are different across orders. They range from \$1.20 per hundredweight for the Upper Midwest order (Minneapolis) to \$4.18 per hundredweight for the Southeast Florida order (Miami). In federal order markets east of the Rocky Mountains, the size of the Class I differential varies with distance from the Upper Midwest. In Western markets, Class I differentials are more uniform and close to the levels set for orders in the Midwest. This difference in determining Class I differentials is because the Western orders face competition from lower-priced Grade A milk in California.

Unlike Class I prices, Class II and Class III prices are the same for all orders. The Class II price is the M-W price for the previous month plus a constant adjustment based on changes in dairy product prices between the past and current month. The Class III price is the M-W price for the current month.

The pooling part of federal milk orders relates to how dairy farmers are paid. Dairy farmers marketing their milk through regulated handlers do not receive the class prices that the handlers are obligated to pay. Rather, farmers receive a *blend price*, which is based on how milk is utilized by all handlers in the marketing area. The blend price is the weighted average price based on the class prices and the utilization of all milk in the market by class. All handlers must pay the same minimum blend price regardless of how they utilize their milk receipts.

The reconciliation between a handler's obligation based on its utilization of milk and its obligation based on the blend price is through a *producer settlement fund*. The producer settlement fund balances handlers' "pool" obligations and the common minimum blend price that they must pay to producers. Handlers who use most of their milk for Class I products have a pool obligation that is higher than the blend price; they pay into the producer settlement fund. Handlers who use most of their milk for Class III purposes have a pool obligation that is less than the blend price; they draw from the producer settlement fund.

Since Class II and Class III prices are the same for all federal orders, blend prices vary across markets according to (1) Class I differentials and (2) Class I utilization. As noted above, Class I differentials range from \$1.20 to \$4.18 per hundredweight. Class I utilization ranges from less than 15 percent to more than 90 percent. In general, Class I utilization is highest in the southeastern U.S. and lowest in the Midwest and Northwest.

Class I differentials and Class I utilization can be used together to measure how much Class I sales in a market contribute to the blend price received by farmers. In Minnesota and Wisconsin, the Class I differential applying to most fluid milk sales is about \$1.30 per hundredweight. About 15 percent of the milk in the two states is used for Class I. Hence, Class I sales contribute about 20 cents per hundredweight over the Class III price ($.15 \times \$1.30$). In Texas, the Class I differential is \$3.28 and Class I utilization is about 50 percent. This means that Class I sales add \$1.64 per hundredweight to the Class III price.

Single Basing Point Pricing

Federal order Class I prices in markets east of the Rocky Mountains are set according to a *single basing point* formula that increases price with distance from Eau Claire, Wisconsin. Class I differentials increase with distance from Eau Claire by about 21 cents per hundredweight per 100 miles. The Class I differential at Eau Claire is \$1.04 per hundredweight. The Class I differential in a market 1,000 miles from Eau Claire is about \$2.10 higher than the Class I differential at Eau Claire, or \$3.04 per hundredweight.

Single basing point pricing was adopted during the 1960s. The justification was that fluid milk processors in distance markets should have an economic incentive to procure milk from the direction of the Upper Midwest, which had a large reserve supply of Grade A milk. The rule ignored the fact that many markets were amply supplied with milk and never had to procure milk from the Upper Midwest.

This curious justification is still used by USDA to defend single basing point pricing despite the fact that little, if any, reserve milk moves from the Upper Midwest to satisfy deficit fluid needs elsewhere. Indeed, substantial volumes of milk now move into the region from areas where milk production has grown so rapidly that it has exceeded manufacturing capacity in the area. The single basing point concept has been turned on its head.

Blend prices vary by market with Class I differentials and the percentage of milk used for Class I. Because of its identification as the basing point, the Upper Midwest has the lowest Class I differential. Because of the dominance of cheese in its dairy product mix, the Upper Midwest has the lowest Class I utilization. Put together, low differentials and low utilization mean that Minnesota and Wisconsin have the lowest minimum blend prices among federal orders.

The mechanical method of geographical price alignment resulting from single basing point pricing is a major cause of the deteriorating viability of dairying in the Upper Midwest, despite many inherent advantages to dairying in the region. The problem is complex, but can be briefly summarized as follows:

1. A general equalization of costs of producing milk among regions occurred beginning in the early 1980s. This was the result of federal feed grain policy, which made it more economical to purchase dairy feeds than to produce them, and technological and genetic changes that enhanced the feasibility and reduced the relative costs of producing milk on large-scale drylot dairy farms uniquely suited to warmer climates.

As the cost of producing milk in regions distant from the Upper Midwest dropped, Class I differentials in markets that experienced a relative cost reduction were not correspondingly reduced to adjust blend prices. Incredibly, just the opposite occurred. In 1986, as part of the 1985 Farm Bill, Class I differentials were increased in many of the same regions that were experiencing lower relative costs of milk production. For example, in

Texas, where milk production was beginning to expand in response to reduced costs, the Class I differential was increased by \$0.96 per hundredweight.

This contrary action yielded blend prices that enhanced excess profitability and created even stronger incentives to expand production. The resulting increase in milk output was inevitable (Figure 3). Because Class I prices were raised by the increase in Class I differentials, fluid milk consumption generally declined in markets granted large increases in Class I differentials. Consequently, the volume of milk utilized for manufactured dairy products increased even more than milk production increased.

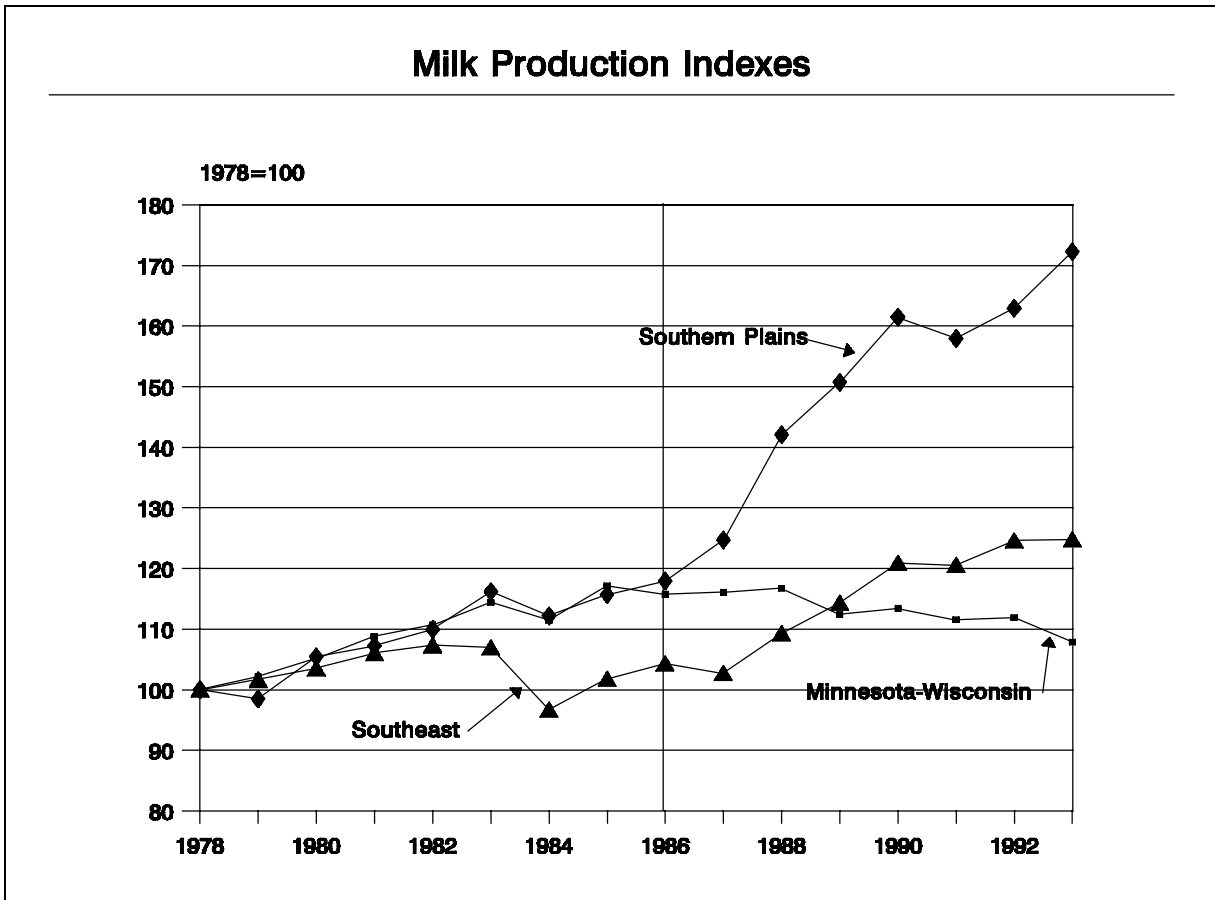


Figure 3

2. Class I differentials are fixed. Hence, the only restraint on milk production in this situation is an erosion of the blend price through a reduction in Class I utilization. Additional Grade A milk production not used in Class I does reduce Class I utilization and, consequently, the blend price. But at the same time, the added production augments the national supply of milk for manufacturing, reducing the M-W Price.

In relatively large markets, such as Texas, most of the erosion in blend price is through a reduction in the M-W price, not through a reduction in the contribution of Class I revenue to the blend price. In other words, any blend price reduction comes mostly at the expense of all producers; not in the form of a localized price decrease in the market where supply is in excess of demand.

3. The M-W Price reduction associated with balancing local supply and demand in this manner is particularly punitive to producers in Minnesota and Wisconsin. That is because Class I differentials in that area are the lowest in the U.S. because of its vicinity to the Eau Claire basing point and because most of the Grade A milk in the region is utilized for manufacturing purposes. Consequently, blend prices are very low.

Costs of milk production differ little among regions. Hence, the reduced M-W Price will likely cause blend prices to fall below the cost of production and force exit of producers in the low-differential, low-utilization markets before supply and demand reach a balance in the expanding markets. This forced exit will limit downward pressure on the M-W price, delaying or completely preventing the ongoing blend price adjustment in the expanding markets.

The ultimate result is a systematic displacement of milk production in the low-utilization markets by production in the expanding markets. This result pertains despite comparable costs of production among the markets, or even lower costs in the low-utilization markets.

4. This systematic displacement is caused by inflexible Class I differentials. In a competitive market, the equilibrium price would fall to balance *local* market supply and demand. Under federal order pricing, the equilibrium price cannot fall as far as necessary because minimum order prices create a lower bound. The linkage between Class I prices and the M-W Price guarantees that the Upper Midwest will suffer the consequences of expanded milk production induced by Class I differentials that are too high in light of local supply and demand conditions.

The M-W Price

The Minnesota-Wisconsin Manufacturing Grade Price Series (M-W price) is the *basic formula price* for all federal milk marketing orders. That means that the M-W price serves as the minimum price for Class III milk (primarily milk used for making cheese) in all orders and as the price "mover" for Class I milk (fluid) and Class II milk (soft manufactured products).⁴

⁴ A fourth class of milk, used to manufacture nonfat dry milk, is priced according to a product formula and is not related to the M-W price.

The M-W Price is a USDA estimate of what Grade B milk plants pay for milk in the two states. Its use in federal milk orders is erroneously justified on grounds that it represents a good indicator of national competition for milk used for manufacturing purposes. The justification is two-fold: (1) Grade A milk in excess of fluid needs must be used to produce the same products that are made from Grade B milk in Minnesota and Wisconsin and must therefore be priced accordingly; and (2) Deficit milk regions draw upon the Upper Midwest for their fluid milk needs; thus conditions in that region influence the value of milk nation-wide.

From a national perspective, the problem with the M-W Price is simple. It is obsolete. There is not enough Grade B milk sold to permit USDA to make a reliable price estimate. Plants are increasingly uninterested in procuring Grade B milk except as a service to long-time patrons. The price is increasingly subject to manipulation.

From the perspective of the Upper Midwest, there are much more serious problems with using the M-W Price as the basic formula price in federal orders. In most markets outside the Upper Midwest, the price that plants actually pay for Grade A milk used for manufacturing is the M-W Price. In the Upper Midwest, excess manufacturing capacity and strong competition for milk to make cheese raises the actual price paid by Grade A plants well above the M-W Price; the gap recently has been \$.75 to \$1.50 per hundredweight. This means that Upper Midwest cheese plants are paying substantially more for milk than their competitors in other regions. Since cheese trades in a national market, this poses a major competitive problem.

Minnesota and Wisconsin cheese plants operate under much less favorable plant margins than do plants in other regions paying substantially less for raw milk. More profitable margins has stimulated new cheese plant expansion in these lower milk cost regions. Milk expansion in these regions has necessitated additional manufacturing plant capacity. But additional plant capacity has also recruited additional milk production to fully utilize this capacity. One feeds on the other. More milk means more plant capacity and more plant capacity means more milk.

Pricing provisions of California's state order allows plants to even pay \$1 or more less than the M-W for Grade A milk used to make cheese. As a result, it has been relatively profitable for California to expand its cheese production. California is now the second to Wisconsin in cheese production and is marketing cheese nationally.

At the same time that milk handlers in many markets pay the M-W Price or less for Class III milk, they can pay their producers more than handlers in the Upper Midwest, who pay much more than the M-W Price for their Class III milk.

This anomaly results from single basing point pricing. High Class I differentials in markets distant from the Upper Midwest mean that large Class I revenues can offset low Class III revenues, yielding a higher producer blend price than what is experienced in the Upper Midwest. The Upper Midwest dairy industry is caught in an insidious competitive box: Plants in the Upper Midwest pay more for milk used to make cheese, meaning that other regions can undercut cheese prices. Producers receive less for their milk than in most other regions but

experience similar or higher costs, meaning that other regions expand milk production while the Upper Midwest contracts.

Continuing to use the M-W Price as an indicator of national supply and demand conditions for milk used for manufacturing exacerbates the problem. The M-W price does not reflect national supply and demand conditions. It reflects regional excess processing capacity, regulated milk prices, rapidly declining Grade B milk production, unusual weather conditions, and a host of other factors that are unique to an area that no longer dominates U.S. milk production.

Tying milk prices throughout the U.S. to the M-W Price assures that milk prices will become increasingly distorted and that the Upper Midwest will be penalized. Conditions in 1993 exemplify this problem. The Upper Midwest experienced major flooding, which resulted in a restricted and poor quality supply of forages. As a result, culling was heavy and milk production per cow on the remaining herd was depressed. This caused milk production in the Upper Midwest to fall dramatically, raising the M-W price. Other dairy areas of the U.S. experienced normal weather and no milk shortages. Yet because the M-W underlies all federal order prices, milk prices in all regions were elevated.

Moving prices nationally according to localized conditions in Minnesota and Wisconsin, where milk production is falling, makes absolutely no economic sense. More important, it has a devastating effect on the two states by encouraging expanded milk production in other areas, subsequently leading to reduced prices for milk used in manufacturing.

Milk Pricing Reform

Ironically, the Upper Midwest's historic importance in dairying is now leading to a diminishing of that importance. Single basing point pricing was instituted because the Upper Midwest was the principal source of reserve milk supplies for other markets. By elevating fluid milk prices in accordance with distance from the region without regard to relative production costs, federal milk marketing orders created incentives for other regions to achieve and surpass self-sufficiency in fluid milk needs.

Single basing point pricing removed natural economic checks and balances on regional milk supplies. It encouraged the production of milk for manufacturing by administratively assuring a blend price to producers that was profitable and much higher than the order-determined value of milk for manufacturing. Single basing point pricing was blind to the leveling of regional milk production costs, virtually assuring the systematic erosion of dairy profitability in the vicinity of the basing point.

The Upper Midwest's importance in dairying led to use of the M-W Price as a measure of national supply and demand conditions for milk. As the region's relative importance diminished, the continued use of the M-W Price to set milk values in other regions allowed those

regions to benefit from a purely local situation that called for higher milk prices locally, but not nationally.

So why hasn't something been done to correct the problem? There have been numerous reform attempts through legislation, administrative proceedings, and the courts. Several bills to eliminate single basing price pricing have been submitted by Wisconsin and Minnesota legislators. None have reached committee. A lengthy Federal order hearing was held in 1990 to address Class I pricing issues. USDA declared that the system was working well and made no changes in Class I pricing, despite a well-organized Upper Midwest challenge to the status quo.

A lawsuit to require the Secretary of Agriculture to end single basing point pricing was filed in Federal district court in January 1990 by the Minnesota Milk Producers Association. After several setbacks and delays, Federal Judge Diana Murphy finally ruled on the case on April 14, 1994. Judge Murphy did not rule current Class I differentials to be illegal. But she did rule USDA's decision to make no changes in differentials based on the 1990 hearing to be "arbitrary and capricious," and ordered the Secretary of Agriculture to provide a reasonable justification for setting Class I differentials. As of this writing, USDA has not announced whether it intends to appeal the decision or conform with the ruling. In any case, the decision represents the only successful step up to this time in terminating single basing point pricing

USDA announced in 1990 that it would no longer stand behind the M-W Price as of July 1992. A national hearing was held in June 1992 to hear proposals for a replacement. There has been no ruling yet. Most of the support at the hearing was for a modified Grade B milk price collected from Minnesota and Wisconsin plants. Replacing the M-W Price with another obsolete indicator of milk value from the Upper Midwest does not solve the problem.

To date, milk pricing regulation has proven largely immune to meaningful reform because more regions are benefitting from regulatory distortions than are being penalized. Hence, the political process, which relies on majority rule, has not been an effective vehicle for change. The Secretary of Agriculture is charged with protecting the public interest in administering federal milk marketing orders. But USDA has elected to administer orders in accordance with majority preference instead of sound economic reasoning and analysis. Hence, the administrative route to order reform has not been effective. The judicial route is still being tested. But even if the Minnesota Milk Producers Association suit is successful, judicial delays could mean substantial further erosion in the dairy sectors of Minnesota and Wisconsin before legally-mandated reforms become effective.