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## **Milk Orders: Selected Topics**

by

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# MILK ORDERS: SELECTED TOPICS

## INTRODUCTION

Government regulation of the dairy economy consists of federal milk order regulations, a commodity price support system, import quotas, and state milk marketing regulations. While price support systems, import quotas and state marketing regulations are used to regulate many agricultural products, the federal milk order system is a program unique to the dairy industry.

Each milk order handed down by the Secretary of Agriculture regulates a specific geographic area perceived as a regional market. Within each order area, the milk order program regulates the purchase of milk by dealers (“handlers” as referred to in the orders). The control of the market is exercised by establishing a minimum price the dealers must pay the farmers (“producers” as referred to in the order).<sup>1</sup> The present system, however, is highly complex and entails much more than a simple minimum price.

Much of this complexity stems from the federal dairy regulations which seek to serve two competing interests. Legislatures have sought to provide farmers milk prices sufficient to cover the costs of production and allow a reasonable return to farmers while at the same time ensuring an adequate supply of pure and wholesome milk at reasonable prices for consumers.<sup>2</sup> What is a reasonable price for consumers, however, may not cover the farmers’ costs and provide a reasonable return. Balancing these interests has been one cause of the milk order system’s complexity.

Another cause of the complexity of milk order regulation is that the problems which the program was meant to address have long since passed. Even so, the scheme of milk order regulation remains basically unchanged. Therefore, the present milk order regulations were designed in response to problems in another era, for a substantially different market. This note will examine problems on two aspects of the present system. Also addressed will be how the present dairy market’s characteristics affect these areas. Initially, however, the history of the legislative enactments and a basic description of how the system works will be presented.

## LEGISLATIVE HISTORY

Congressional enactments concerned with the agricultural sector have become commonplace. In what has become a four year cycle, the national legislature develops a farm bill. Modifications of the terms and concepts contained in each farm bill continue every year. There have been several major Congressional enactments which have substantially affected the dairy industry and led to the milk order system as it exists today.

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1. *See, e.g.*, 7 C.F.R. § 1036.9-12 (1985).

2. Agricultural Adjustment Act of 1933, Pub. L. No. 73-10, 48 Stat. 31 (codified at 7 U.S.C. § 601 (1982)).

Federal regulation of the dairy industry first began as a response to the drastic slide in farm purchasing power during the Great Depression. After the inauguration of Franklin D. Roosevelt, Congress passed several bills which allotted increased power to the federal government for the purpose of "supporting" (i.e., fixing or raising) farm prices for commodities.<sup>3</sup> The initial bill was the Agricultural Adjustment Act of 1933.<sup>4</sup> The basic goal of the Act was the restoration of farm purchasing power.<sup>5</sup> Within the commodities supported, Congress included milk and its byproducts.

Three basic mechanisms within the 1933 Act applied to the dairy industry. First, the law gave the Department of Agriculture the authority to regulate the marketing of commodities by allowing them to enter into voluntary agreements with handlers of dairy products. The law also permitted the licensing of market participants in order to facilitate the elimination of unfair practices or charges. Finally, the Department of Agriculture was given the responsibility to determine the necessity of processing taxes. The proceeds of the tax would be used in offsetting the cost of adjustment operations to support commodities.<sup>6</sup>

The Agricultural Act of 1935<sup>7</sup> amended the Agricultural Act of 1933. The new system authorized the substitution of marketing orders for agreements and licenses. These marketing orders regulated a commodity market by controlling the terms under which it could be sold. Also, the new orders could be issued without any voluntary marketing agreements being reached between the Secretary of Agriculture and the farmers.

The Agricultural Marketing Agreement Act of 1937<sup>8</sup> separated the dairy industry regulation from the regulation of other agricultural commodities. The new dairy program instituted price classification according to use.<sup>9</sup> This price classification scheme required dealers to pay a minimum price for the milk purchased, based on their use of the milk. Thus, depending on the order, milk purchased for fluid consumption would command a different price than that purchased for the production of cheese.

The minimum price was not the price received by the farmers. They received a unit price. The total amount paid by the handlers was pooled and distributed to the farmers according to the amount of milk they sold without regard to the use to which it was put. In effect, farmers received an average of the different prices paid in each class weighted by how much milk was sold in the class.<sup>10</sup>

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3. Snyder, *A Summary: Political and Economic Analysis of Milk Marketing, 1980-1981* AGRIC. L.J. 297, 322.

4. Agricultural Adjustment Act of 1933, *supra* note 2.

5. Snyder, *supra* note 3, at 322.

6. Agricultural Adjustment Act of 1933, *supra* note 2, at 35.

7. Agricultural Act of 1935, Pub. L. No. 74-320, 49 Stat. 750 (codified at 7 U.S.C. § 602 (1982)).

8. Agricultural Marketing Agreement Act of 1937, Pub. L. No. 75-137, 50 Stat. 246 (codified at 7 U.S.C. § 608c (1982)).

9. 7 U.S.C. § 608c(5)(A) (1982).

10. Snyder, *supra* note 3, at 328.

The next enactment to have an impact on the dairy industry, the Food and Agricultural Act of 1965,<sup>11</sup> offered farmers in an order area an alternative voluntary program designed to curtail surplus milk production. This program became operative when approved by producers in a milk marketing area.<sup>12</sup> Upon enactment, each dairy producer was assigned a level of production that he could supply to the higher priced use-classifications in the order area.<sup>13</sup> If a farmer produced at or below this level, he would receive the higher use price.<sup>14</sup> Any production above that base could only be sold at the lower price uses.<sup>15</sup>

Further enactments have retained the basic scheme of use-classified pricing in the milk order regulations. Although terms may differ, the milk order system remains basically the same as that enacted in 1937.<sup>16</sup> Therefore, the functions of the milk order system, and the procedures applicable to different parties have remained unchanged for nearly fifty years.

### PROCEDURE

The use-classified system of pricing classifies "milk in accordance with the form in which or the purpose for which it is used."<sup>17</sup> It also provides a formula fixing the minimum price for milk in each class.<sup>18</sup> Although other classifications exist,<sup>19</sup> for the sake of simplicity, this note will limit its discussions and examples to the two-tiered system.

The classification in a two-tiered system divides milk into two categories—fluid or manufacturing use.<sup>20</sup> Fluid use or Class I, includes most fluid milk products such as milk, buttermilk, and similar products.<sup>21</sup> Manufacturing use or Class II, generally includes milk used in products such as cottage cheese, sour cream, butter, and cheese.<sup>22</sup>

The milk order regulation sets prices that dealers pay for each class of milk. This price, however, is not paid to the delivering farmer.<sup>23</sup> The farmer receives a blend price which is a weighted average of the total milk sales in an order area.<sup>24</sup> Regardless of which class dealer a particular farmer sells to, he

11. Food and Agricultural Act of 1965, Pub. L. No. 89-321, 79 Stat. 1187 (codified at 7 U.S.C. § 608c (1982)).

12. *Id.* at 1187.

13. *Id.*

14. *Id.*

15. *Id.*

16. See 7 C.F.R. § 1036.40 (1985).

17. 7 U.S.C. § 608c(5)(A) (1982).

18. *Id.*

19. See 7 C.F.R. § 1036.40 (1985).

20. See 7 C.F.R. § 1012.40 (1985).

21. See 7 C.F.R. § 1012.40(a) (1985).

22. See 7 C.F.R. § 1012.40(b) (1985).

23. See 7 C.F.R. § 1012.60 (1985).

24. For example, if dealers purchased 100 units of milk and 60 were sold to Class I dealers, while 40 were sold to Class II dealers, and the Class I price was 2 and the Class II price was 1, then the total receipts in the order area would equal (60 (units sold to Class I) @ 2) + (40 (units sold to Class II) @ 1) = 120 + 40 = 160. Thus, the total receipts for 100 units of milk sold would be 160 or 1.6 per unit of milk.

This calculation can be represented by the formula: Blend Price = (QiPi + QiiPii)/(Qi + Qii). Qi represents the quantity of milk demanded for Class I uses. Qii represents the quantity of milk

receives the same price for each unit of milk he sells.<sup>25</sup>

Different formulas have been used by the Department of Agriculture to fix minimum class prices.<sup>26</sup> Presently, the minimum price in all federal milk orders is determined by the Department of Agriculture through the use of a monthly sampling of actual prices paid to producers of grade B milk by unregulated plants in Minnesota and Wisconsin.<sup>27</sup> This statistical sampling is called the Minnesota-Wisconsin Price Series (M-W Series), and is a reference point for the current value of milk in an unregulated market. Federal price supports, however, have an impact on dairy prices throughout the United States, including Minnesota and Wisconsin. The M-W Series, therefore, is not a true free market price.<sup>28</sup> It is only a price which is not directly set by federal marketing orders.

Once the minimum prices are set according to the M-W Series, differentials between the class prices actually paid are applied. These take into account such factors as distance from producers, butterfat content, and the availability of milk within an order area.<sup>29</sup> Also, adjustments are made based on the location where delivery is made to dealers, recognizing that additional costs are incurred by dealers in transporting outlying deliveries to consumer markets.<sup>30</sup> In general, the differentials and adjustments operate to equate all dealers by offsetting economic advantages or disadvantages. In addition, they equate farmers in the order area. By providing incentives for dealers to treat farmers equally, regardless of their location, the order differentials and adjustments also eliminate economic decisions that would harm outlying dairy producers.

The promulgation of a new order or the amendment of an existing one in the dairy sector becomes effective only upon approval of producers and the Secretary of Agriculture.<sup>31</sup> Even though an administrative process<sup>32</sup> complete with testimony pro and con may determine the necessity of change, such change must be approved by the producers.<sup>33</sup> Although a referendum is required only in the case of the promulgation of a new order,<sup>34</sup> a two-thirds majority of producers, either by number or volume, within a marketing area is required to approve an order before it can take effect.<sup>35</sup>

A component of the dairy market which plays a significant role in the operations of the milk order regulatory scheme is the producer cooperative. Congress affords special recognition and privileges to producer cooperative

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demand for Class II uses. Pi represents Class I price. Pii represents Class II price. See 7 C.F.R. § 1012.60 (1985).

25. 1 AGRICULTURAL LAW 130 (J. Davidson ed. 1980).

26. *Id.* at 117.

27. See 7 C.F.R. § 1012.51 (1985).

28. 1 AGRICULTURAL LAW, *supra* note 25, at 117.

29. See 7 C.F.R. § 1012.74-75 (1985).

30. See 7 C.F.R. § 1012.52 (1985).

31. 7 U.S.C. § 608c(3), (4) and (19) (1982).

32. 7 U.S.C. § 608c(3) (1982).

33. 7 U.S.C. § 608c(8)-(9) (1982).

34. 7 U.S.C. § 608c(19) (1982).

35. 7 U.S.C. § 608c(8)-(9) (1982).

associations participating in the regulated market. Congress allows such organizations a limited antitrust exemption<sup>36</sup> and protects the free choice of farmers to join cooperatives.<sup>37</sup> Other benefits include the right to collect the receipts of their members and the right to distribute them pursuant to a rebled formula of the associations' own devise.<sup>38</sup> Furthermore, the cooperative associations are allowed to vote as a block pursuant to a majority of their members wishes. Thus, the promulgation referendum and amendment approval in milk order regulations need only have the support of producer cooperatives with memberships or volume greater than two-thirds of the order area's total.<sup>39</sup>

### ANALYSIS

The current milk marketing order system receives criticisms from many sources and differing positions.<sup>40</sup> Two areas frequently commented on are the voting power the cooperatives possess and the concept of a minimum price for dairy products. One facet of the producer cooperatives' privileges that is subject to debate is the possibility a minority of farmers in an order area may effectively control it.<sup>41</sup> Another area subject to attack is the concept of a supported minimum price.<sup>42</sup> Granted, there exists a possibility that abuse in the cooperative system will occur. There is, however, no easy solution to abuse of the voting privilege. Also, while a free market may equate supply and demand, it appears that minimum prices further the governmental goal of ensuring consumers have an adequate supply at reasonable prices.

As mentioned previously, a producer cooperative may vote as a block according to the wishes of a majority of its members.<sup>43</sup> This ability allows a cooperative to exercise inordinate weight in the approval process of a promulgation or amendment of a new milk order.<sup>44</sup> The voluntary nature of membership in the producer cooperatives, however, is a countervailing force which often prevents a minority from controlling the market.<sup>45</sup> Even so, the larger the percentage of farmers in an order that the cooperative represents, the more

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36. Capper-Volstead Act, Pub. L. No. 67-146, 42 Stat. 388 (1922) (codified at 7 U.S.C. §§ 291-292 (1982)).

37. *Id.*

38. 7 U.S.C. § 608c(5)(F) (1982). *See, United States v. Rock Royal Cooperative*, 307 U.S. 533, 579 (1939).

39. 7 U.S.C. § 608c(12) (1982).

40. *See generally* FEDERAL MILK MARKETING ORDERS AND PRICE SUPPORTS 97-112 (P. MacAvoy ed. 1977).

41. Snyder, *supra* note 3, at 351.

42. Belongia, *The Dairy Price Support Program: A Study of Misdirected Economic Incentives*, 66(2) REVIEW: FEDERAL RESERVE BANK OF ST. LOUIS 5, 14 (1984).

43. 7 U.S.C. § 608c(12) (1982).

44. For example, in an order area with 100 farmers, 67 votes in favor of a new order or an amendment to an existing one are required. Since a producer cooperative can vote its membership as a block, one cooperative or a combination of more than one voting similarly, with a membership of 67, could control the vote. In addition, if the cooperative or the group of cooperatives voted according to the wishes of a majority of their members, 34 farmers could exercise control in the order area.

45. Continuing the example in note 44, after a vote on an order promulgation or amendment, an unhappy cooperative member could disenroll from the association. Such a disenrollment would leave our example cooperative with 66 members, a fraction short of the two-thirds majority required. This

powerful its vote, and less significant a dissenter's defection will be. If a cooperative is large, however, more of its members are needed for a majority within the organization. Thus, while a defection may not impact as heavily upon a cooperative with a membership containing a large percentage of farmers in an order area, the organization must nonetheless work to represent its members' wishes or lose their support.

While it may be contended that the cooperatives may allow rule by the minority, such a result is not automatic. For a cooperative to control, it must faithfully represent its farmers, and keep those members who disagree with a position loyal, regardless of opposing viewpoints. In essence, the cooperative's majority in a vote must consist of those agreeing as well as those conceding to the wishes of the majority of their fellow members.<sup>46</sup>

A related problem is raised when the requisite majority is reached through the votes of producers whose production volume exceeds two-thirds of the order area's volume. Hypothetically, one producer with sixty-seven percent of the production volume in the order area could control the voting. More realistically, a concerted effort by a small group of large producers, with similar interests could dominate the voting in the promulgation or amendment of a milk order. In effect, the volume aspect of the cooperative block voting privilege weighs against smaller producers.

On the other hand, a block voting privilege based only on membership, would operate to allow the smaller producers control over the market disproportionate to their market participation.<sup>47</sup> Thus, the problem of abuse in the block voting privilege is not easily answerable. A formula could be used to distribute voting power that takes into account democratic as well as economic concerns. Implementation of such a formula might alleviate the problem but would also add to the morass of the already complicated milk marketing system. It appears, therefore, that the best approach to this problem is to rely on the voluntary nature of cooperative membership to control cooperative power.

As mentioned previously, some critics of the milk marketing system contend that the bolstering of a minimum price with a price support mechanism serves to artificially inflate prices, creating excess production and requiring purchases of excess production with tax dollars.<sup>48</sup> The argument posits that the loosening or removal of minimum prices would create a freer market and demand and supply would seek an equilibrium price. Excess production

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possibility of loss of voting power serves to mitigate the autocratic control a minority of the producers in the market may possess.

46. Comment, *Agricultural Cooperatives: Gain of Market Power and the Antitrust Exemption*, 27 S.D.L. REV. 476, 494 (1982).

47. Theoretically, one superproducer may supply 99% of the milk in an order area, while the remaining one percent of the milk comes from the remainder of the producers in the area. If the rest of the producers were members of a cooperative which had at least a two-thirds majority (at least three in this case), however, and a vote was based upon a one producer/one vote format, their association could dictate the milk order parameters, despite the fact that their combined economic effect on the market was negligible.

48. *Belongia*, *supra* note 42, at 14.

would then disappear and price support purchases would cease to be needed.<sup>49</sup>

If the milk marketing system was to remain in effect without government price support purchases, downward pressure on prices would result because the excess supply would not be demanded by the market at the minimum price. While the Secretary of Agriculture could remain firm and require that excessive prices be maintained, this would be contrary to the functioning of the market. Because no dealer could purchase at a lower price, and the market would be saturated at the higher price, the farmer would have no market for his product.

The dairy price supports, by purchasing excess production, actually operate to maintain the viability of the minimum price.<sup>50</sup> Removal of price supports would undermine the minimum price and the milk marketing system as a whole. Paralleling its reinforcement of the milk order system, the price support system also advances the major policies behind the federal involvement in the dairy industry.

As mentioned above, the purposes behind the system are to provide farmers milk prices sufficient to cover their costs of production and allow them a reasonable return, while ensuring an adequate supply of pure and wholesome milk at reasonable prices for consumers.<sup>51</sup> If the minimum prices were removed or reduced to and maintained at the level where no excess production existed, changes in the production or supply side of the dairy market would have to occur. These changes would contradict one of the explicit policies behind the milk order regulations.<sup>52</sup> Because of inherent conditions in the agricultural sector, a freely fluctuating price would not ensure the supply needed to achieve the purpose of maintaining an adequate supply at reasonable prices for consumers.<sup>53</sup> The supply of dairy products changes slowly when changes in price occur, because in general, a large change in price must occur before supply changes significantly.<sup>54</sup> Several characteristics contribute to this slow reaction.

The dairy industry, like the agricultural sector in general, is a capital

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49. *Id.*

50. Snyder, *supra* note 3, at 329.

51. Agricultural Adjustment Act of 1933, *supra* note 2, at 36.

52. *Id.*

53. These inherent conditions are known as price elasticities. Price elasticity quantifies the relationship between price and quantity by comparing the changes in price and quantity in relation to each other. The price elasticity of supply indicates the degree of change in the quantity of an item supplied by producers that would be induced by a given change in the price of that item. The magnitude of elasticity is represented by the elasticity figure. An elasticity figure greater than one represents an elastic relationship where quantity changes proportionately greater than price. On the other hand, an elasticity figure less than one represents an inelastic relationship where quantity changes proportionately less than price.

54. As producers, the dairy farmers react as represented by the elasticity of supply. The elasticity figure for supply equals the percent change in the quantity supplied, divided by the percent change in price per unit. In general, the agricultural sector as a supplier is price inelastic. Thus, the elasticity figure is less than one. In other words, for every percent change in commodity prices, a smaller percent change occurs in quantity supplied. Snyder, *supra* note 3, at 304 (citing G. JOHNSON & C. QUANCE, *THE OVERPRODUCTION TRAP IN U.S. AGRICULTURE* 20 (1972) [hereinafter cited as *OVERPRODUCTION*]).



intensive economy.<sup>55</sup> Large expenditures are required to move more cows into production. Necessary facilities must be constructed, and more land and machinery must be acquired to raise the necessary feed. But most importantly, the specialized milk cow of today must either be bought or raised.

Because of these factors, in the short run, the dairy market reacts slowly to price changes. As a result, the price of milk must move significantly to effect a move in the same direction from the supply.<sup>56</sup> Demand led price increases must be of a magnitude sufficiently large to meet short run market demand fluctuations. The situation is less dramatic in the long run. By definition, the long run is an amount of time needed for producers to change the capital makeup of their farm. Much smaller price changes are required to affect supply in the long run.<sup>57</sup>

It might be suggested that because the magnitude of the required changes in prices over the long run would not be as large as those in the short run, the problem of slow adjustment of milk supplied would not be as severe. Farmers would have time to adjust their operations to produce an adequate supply at a reasonable price and the long run equilibrium point would not require supports. Even in the long run, however, the changes in quantity supplied in response to price fluctuations depend on which way the price is moving. To effect equal movements in the quantity supplied, a rising price must move twice as far as a falling one.<sup>58</sup> In effect, to increase supply over the long run would require price changes of a greater magnitude than those needed to decrease it.

A large part of the reason this characteristic exists is again because of the capital intensive nature of the farm economy. In the face of long term price reductions, farmers like any other investor move their capital to areas of better return. Also, in the long term, they have the time to effect these changes and nature's cycles play less of a part so when long term price reductions occur, supply of dairy products decreases.

In time of increasing prices, a farmer again plays the good investor. Factors working against greater investment and the supply which follows, include caution and nature. Because farming requires significant amounts of capital, a wise investor plans his action carefully. Also, the vagaries of nature warrant caution. Return on investment depends upon the cycles of the weather. A bumper return one year can be offset the next by drought or flood. Thus, the

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55. *Id.* at 305.

56. In times of decreasing farm prices, the short run elasticity figure stands at 0.15. In other words, for every 10% drop in price, the supply of a commodity decreases 1.5%. When farm prices are on the rise, the elasticity figure decreases to 0.10. Thus, the supply of a commodity climbs only 1% with every 10% rise in price. Snyder, *supra* note 3, at 304 (citing OVERPRODUCTION, *supra* note 54, at 20).

57. In the long run the elasticity of supply changes. If prices fall over the long run, supply drops 15% for every 10% lost in price. This elastic result is reflected in an elasticity figure of 1.5. However, in times of increasing prices, the agricultural sector is again price inelastic with an elasticity figure of 0.80. Thus, for every 10% increase in prices, supply increases only 8%. Snyder, *supra* note 3, at 304 (citing OVERPRODUCTION, *supra* note 54, at 20).

58. *Id.*

investment required for supply moves slowly and carefully, not responding dramatically to prospects of increased return.

Combined in a free market these characteristics of price and supply would threaten the goal of providing an adequate supply of milk at reasonable prices. Demand increases would require significant price rises in order to adequately increase supply to meet the larger demand in the short term.<sup>59</sup> Supplying an adequate amount of milk may be possible, but whether the price at which it is offered is reasonable would be a point of contention.

A more serious problem in a free market would occur directly following the removal of a minimum price. The present price support surplus, the source of much of the criticism in the area, evidences a supply exceeding demand at the present supported price. Removal of the minimum price would decrease the price and quantity of the milk supplied.

Assuming the quantity of milk demanded by the consumers at different price levels remained unchanged long enough for a long term adjustment, an equilibrium point would be reached where the price and supply of milk was lower than when minimum prices were in effect. Farmers would adjust their operations by moving capital to areas where a better return could be attained. Concurrent with the drop in prices, consumers would demand more, but not as much as was previously produced. Over time, the market would settle as prices lowered with long term supply reduction greater than the increased demand. Short term fluctuations that occurred would move the market as described above.

If the consumer market of milk underwent changes that significantly altered the long term demand, the legislative goals behind the system would be threatened. Recall that the magnitude of price increases required for a long term increase in supply were almost double the price decreases required for an equal reduction in supply.<sup>60</sup> After the removal of supports, the recapture of reduced production will require price increases nearly double the absolute value of the earlier reductions. With such an obstacle, the long term goals of ensuring consumers adequate supplies of milk at reasonable prices would be threatened. Although minor variations would not lead to serious problems, demand increases of any magnitude would increase prices significantly. Also, if because of financial troubles or weather problems the supply of milk was reduced, large price increases would be needed to increase the production of those unaffected by the trouble or to lure new farmers into the market.

If Congress was to revise its goals of farm regulation, perhaps a system without minimum prices would suffice. At present, however, consumer protection is a major objective of the system. Granted, if no minimum price for dairy products was supported, farmers would suffer while the burden to the

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59. Seasonal fluctuations occur in the short run. Due to lactation and gestation cycles milk production is higher in the spring with the same amount of investment constant throughout the year. Demand, however, is higher in the fall. FEDERAL MILK MARKETING ORDERS AND PRICE SUPPORTS, *supra* note 40, at 30.

60. Snyder, *supra* note 3, at 304 (citing OVERPRODUCTION, *supra* note 54, at 20).

taxpayers would be reduced. In a free unsupported market, however, consumers may initially benefit from lower prices but severe detriment would occur as soon as demand increased. Thus, while removal of supported minimum prices will benefit some nonfarmers, others will suffer.

The milk marketing order system has been an integral part of the dairy economy for a long period of time. During that period the farm sector has undergone dramatic changes. Instead of the labor intensive methods used when the present system was first enacted, farms are now capital intensive. The dairy industry has developed under the system such that its goals are met. Although the system may not be the optimum in many regards, care must be taken in any changes enacted such that the dairy industry's characteristics do not operate to impose burdens on the farmers or consumers.

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