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Hearing Clerk
Room 1081, South Building
14th and Independence, SW
Washington, D.C. 20230
Attention: LaWuan Waring

RE: Brief to USDA re: Federal Milk Market Order Hearing
Docket No. AO-14-A69 et al

On May 10, 2000, Joaquin Contente, president of the California Farmers Union, presented testimony to USDA regarding revisions to Class III and IV pricing. Mr. Contente, who owns and operates a dairy farm in California, testified on behalf of the National Farmers Union (NFU). In his testimony, Mr. Contente explained how California's end product pricing system has affected producers in his state. He described a system where producers were forced to increase herd size to maintain their cash flow and increase their access to credit. He explained that the state make allowance, which was higher than the rest of the country, benefited the processing industry, but resulted in lower prices and surplus production for producers. He concluded that:

1. USDA should lower the manufacturing allowance, hereafter referred to as make allowance.
2. The make allowance should be variable, tied to farm price and cost of production.

RESPONSE TO ISSUES RAISED AT THE HEARING

1. The pricing system adopted by the final rule is flawed because it does not give the processor the incentive to sell the finished product at the best possible price for producers.

On behalf of NFU, Mr. Contente argued that the system adopted by the final order is flawed. Producers are paid according to the price processors obtain for dairy products. Yet, under the system adopted by the final rule, there is no incentive for the processor to obtain a high market price, since the processor is paid through the manufacturing allowance, hereafter referred to as the make allowance.

The testimony of Dr. Robert Yonkers, presented on behalf of the International Dairy Foods Association, supports the conclusion that processors are not financially rewarded for selling products at a higher price. (See Yonkers, page 8.)

On page 8 of his testimony, Dr. Yonkers states that under the formula adopted in the final rule, processors have no way to recover their costs, except through the make allowance. He explains that raising the price of the finished product provides no additional money to the processor, since the increase in the product price must go to the producer.

If one agrees with the Yonkers statement, one may also conclude that a system based on end product pricing can actually give processors a disincentive to sell for a high price, since by lowering the price, the processors may increase their sales market share—and by doing so, increase profit by receiving the make allowance on a larger volume.

In order to send accurate market signals to both producers and processors, NFU supports linking the formula that pays processors to producer prices and producer costs.

2. The formula in the final rule fails to capture the full value of the milk provided by the producer.

The final rule depends on National Agricultural Statistics Survey (NASS) prices. However, the NASS survey collects prices for cheddar cheese, but not mozzarella cheese. This hurts producers since a significant amount of cheese milk is used to produce mozzarella and mozzarella has a higher value than cheddar cheese.

In California alone, there were 1,404,698,000 pounds of cheese produced in 1999. Of that total, mozzarella accounted for 655,886,000 pounds of the cheese produced. Yet, the producer price is based on the lower-value cheddar cheese.

NFU supports three changes to improve the NASS survey.

1. Mozzarella should be included in the cheese survey.
2. All plants should be required to participate in the survey.
3. Prices should be audited for accuracy.

3. A make allowance that is too high will harm producers in several ways, by lowering the farmgate price, sending false market signals, and providing extra funds that can be used to undercut the market.

Dr. Yonkers argues that if USDA errs on setting the make allowance, it should err on the high side, since the additional money will be returned to producers through over-order premiums. That statement fails to recognize the significant harm caused by a make allowance that is too high.

Since the make allowance is deducted from the product prices used in the formula, each dollar paid for the make allowance produces a corresponding reduction in producer price. However, a make allowance that is too high is detrimental in other ways as well. It results in processors calling for increased production, whether or not the market needs the production. It also provides extra funds that can be used by processors to "buy down" or cut their product prices, thereby undercutting the end product pricing system. (See Contente testimony.)

The Yonkers testimony argues that a make allowance that is too low to cover the cost of production jeopardizes the survival of the plants. (See pages 54-58 of the Yonkers statement.)

Producers are fully aware of the importance of obtaining the cost of production. However, the Yonkers statement appears to overstate the danger of a low make allowance. His statement is only true if the product formula captures every bit of value of the producers' milk, and returns that value to the producers. If the product formula fails to capture the full value of the milk, then the additional value not captured by the formula is also available to processors.

Dr. Yonker's statement makes numerous pleas for cost of production on behalf of the processor, and yet rejects the cost of production for producers. (See page 58.) We believe Dr. Yonkers errs by failing to take into account the section of AMAA of 1937, which requires the agriculture secretary to balance several factors in establishing milk prices. This balance requires consideration when the national parity price for milk does not cover the price of feeds, the available supplies of feeds, and other economic conditions.

4. The make allowance in the federal order is too high.

There was widespread agreement among witnesses representing dairy producers at the hearing that the make allowance in the final rule is too high.

Even testimony by Dr. Yonkers raises this issue. On page 53, Dr. Yonkers testifies that the 70-cent difference between the Class IV and Class II skim milk price is an estimate of the cost of drying condensed milk and re-wetting the solids to be used in Class II products. Yet, the make allowance set at 13.7 cents per pound of nonfat dry milk using an 8.6 yield factor results in an allowance of $1.178 per pound of nonfat dry milk.

5. The system should contain verification procedures to ensure that producers are paid for milk based on the class of product for which it is used.

Producers should be paid for milk based on the class of product for which it is used, i.e., if milk is turned into non-fat-dry powder but then used to make cheese, the producer should be paid based on the cheese value. USDA may need to implement procedures for further verification as to the use of the milk.

6. The experience of the first six months under the new federal market order indicates that Class III pricing may need adjusting.

The first six months of this year have produced a wide price gap between Class III and Class IV. It has also resulted in the Class III price falling far below the support price.

At a minimum, USDA should increase the Commodity Credit Corporation (CCC) purchase price for cheese. In addition, the formula should be reviewed for errors, since the wide price disparity was apparently unexpected.

National Farmers Union rejects that argument that the disparity should be "fixed" by lowering the butter price. This is especially true since the United States producers are experiencing prices far below the cost of production, <u>even though the United States produces less milk than it consumes.</u>

7. NFU supports maintaining the 3-cent adjustment adopted by the NASS survey to reflect the difference between the block and barrel prices for cheese.

NFU opposes using the 1-cent adjustment recommended by Dr. Yonkers. NASS adopted the formula adjustment to reflect the historic difference the price between blocks and barrels of cheese. The formula should continue to reflect the historic 3-cent spread between 40-pound blocks and 500-pound barrels.

8. USDA should avoid a California-style pricing system.

Witnesses with experience under the California system, representing the National Farmers Union, the National Farmers Organization (NFO), and the Alliance of Western States, urged USDA to avoid adopting a California-style dairy pricing system. NFU would like to support the reintroduction of the testimony given on behalf of the NFO by Francis Pacheco. NFU would also like to support the portion of the testimony presented on behalf of the Alliance of Western States that urged USDA to avoid adopting a make allowance system that is similar to the California system.

In addition, NFU is supportive of testimony presented by Dr. David Barbano that urges changes to the dairy pricing system to make it more equitable for dairy producers.

Conclusion

USDA should use the experience of California in predicting the probable result of a federal order system based on component pricing. If success is measured by increased production alone, then the California system has worked. However, the costs to producers and society have been high. California has experienced lower producer prices, more concentrated dairy operations, and increased water problems. Surplus non-fat-dry milk has required government purchases.

The challenge for USDA is to develop a system that will link the fortunes of processors and producers, to give each the proper market signals and incentives to produce a healthful supply of dairy products. Lowering the make allowance and linking the make allowance to producer costs and prices will help USDA ensure a sustainable system for future generations.