2023 National Federal Milk Marketing Order Pricing Formula Hearing

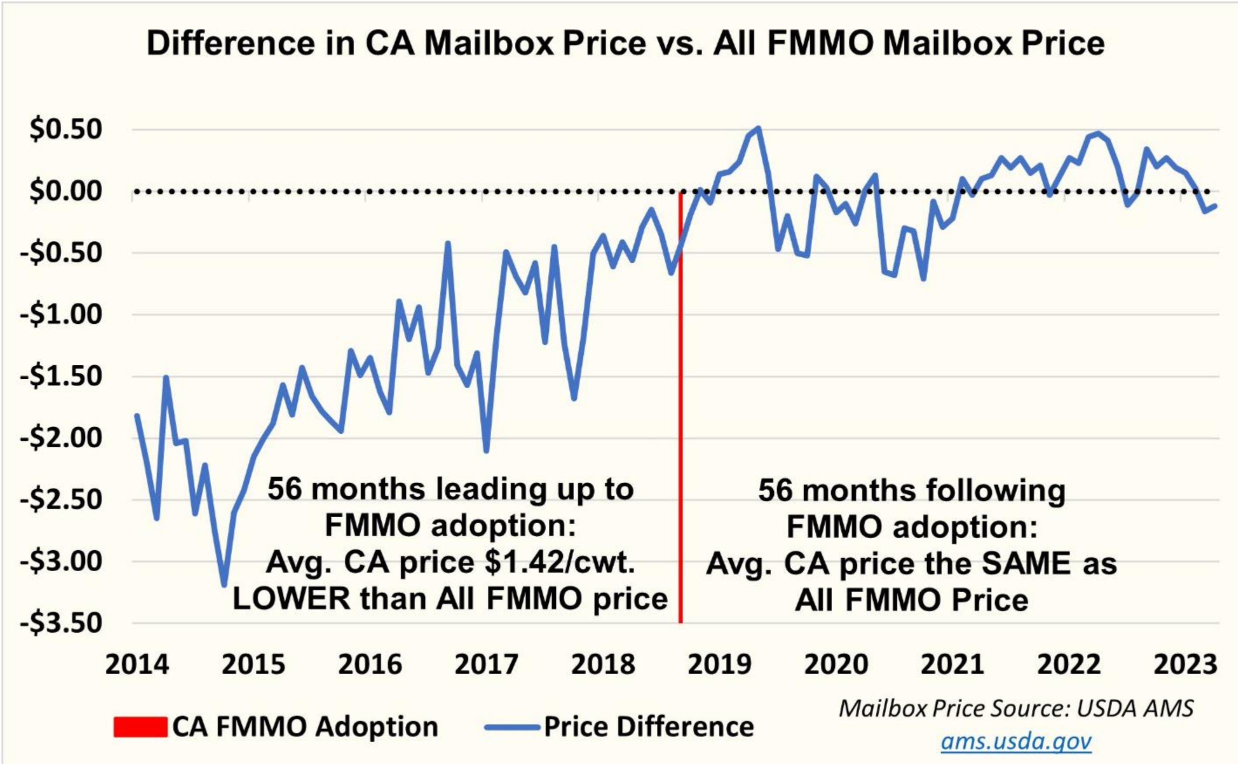
Carmel, Indiana

Testimony of Geoff Vanden Heuvel, Director of Regulatory and Economic Affairs

Milk Producers Council- California

Milk Producers Council is a nonprofit organization representing dairy families throughout California. Since 1949, our board of directors and staff have worked on behalf of our members on local, state and national issues, with topics ranging from milk pricing policies to environmental regulations and any other regulatory and policy challenges facing dairy families today. My name is Geoff Vanden Heuvel, and I have been the Director of Regulatory and Economic Affairs for MPC since June of 2018. Prior to that I was a dairy farmer, operating for nearly 39 years in Southern California. I also served as a board member of MPC since the early 1990s and prior to that served on the board of another dairy farmer trade association. I was an active participant in the California State Milk Order, testifying at nearly every milk pricing hearing held by the California Department of Food and Agriculture since 1985. I testified at the Federal Order Reform formulation hearing in Alexandria, Virginia in May of 2000 as a witness for Select/Continental and Elite cooperatives and the Western States Dairy Producer Trade Association. My expertise was on the California pricing system, which utilized a product value formula to establish minimum pricing for the State Order. Since federal order reform was moving the FMMO system to a product value formula system in 2000, I was able to provide some knowledge and experience about how that system worked in California.

Before I get too far into this testimony, Milk Producers Council wants to thank USDA for responding positively to the California producer community's request to come under the jurisdiction of the FMMO program. The California FMMO hearing was long. It lasted nearly 40 days and required a significant investment of time, money and effort by all concerned. I am here to report that the California Federal Milk Marketing Order has had a significant impact on the mailbox price of California producers. The chart below is a visual demonstration of that impact.



Bottom line: Multiplying the $1 plus increase in average California producer mailbox prices that occurred after the establishment of the California FMMO in November of 2018 times the over 40 billion pounds of annual California milk production results in an increase of over $400 million in annual California producer income. In addition, and even more important, is the fact that California producers are now on a level policy playing field with our colleagues in the rest of the Federal Order system. That fact has benefits not only for California producers, but also supports the ability of USDA to sustain a national, coordinated dairy pricing policy and regulation. It took a tremendous amount of effort by many people in the industry and many people at USDA to get this result, and we are profoundly grateful.

Moving on to the subjects that are part of the call of this hearing. The government is involved in milk price regulation because long ago we decided as a nation that an ample supply of fresh and wholesome milk at prices that were affordable for consumers was in the public interest. The perishable nature of milk and the inherent imbalance in market power that that perishability creates is what leads to a role for the government to become the referee between milk processors and producers. In a normal business relationship, sellers do not have to sell, and buyers do not have to buy. A transaction occurs when a willing buyer and a willing seller agree to a price. When it comes to milk, because it is highly perishable, the producer cannot hold his product. The processor does not have to buy, at least not that day. And so, this leads to an imbalance in marketing power between producers and processors.

What we have today in the Federal Milk Marketing Order program is the result of over 85 years of the government playing the role of a referee amongst the various actors in the dairy industry. What has made this system work for so long has been the fact that the FMMO system **discovers** the value of milk – it does not bureaucratically establish that value. It then transmits that market value though the regulation to establish appropriate minimum prices for the various uses of milk.

The starting point for building a market-based regulatory system is finding a competitive value for milk. For decades the Minnesota-Wisconsin price series provided this price discovery. Dairy plants buying raw unregulated grade B milk in Minnesota and Wisconsin were surveyed and reported what they paid for milk in an unregulated market. There were no explicit make allowances or yields in the pricing series. Simply a hundredweight value and a components test. This milk price then became the building block for establishing regulated Grade A milk prices in the FMMO system. Eventually, there was not enough unregulated Grade B milk in Minnesota and Wisconsin to confidently use this price series to accurately determine the market value of raw milk. The alternative was to move one step away from raw milk and use basic products made from milk as the starting point, and then back into a milk value by adjusting for yields and conversion costs. This is the system we have today, and this hearing is about updating the various parts of the conversion formulas that are used to discover the competitive value of milk.

The understanding that we are trying to discover the value of milk, shapes our positions on the various proposals that are part of this hearing. There are a number of competing interests that have to be balanced as these adjustments are considered. MPC greatly appreciates the care and deliberation the National Milk Producers Federation went through to develop their package of five proposals. MPC endorses and supports the entire package.

MPC supports Proposal 1 by NMPF and has no objection to proposal 2 by National All Jersey. Both of which seek to adjust the component values in the class III and IV skim milk price formulas to reflect higher solids content in average producer milk in the country. We hear the objections by the Class I handlers that they do not have the ability to recover the value of the increased standard components which proposal 1 and 2 suggest. Our response is that the handlers' objections are missing the point. What the FMMO formulas do is establish a base value from which the Class I value is derived. Dairymen have increased the component levels in raw milk over the past 20 years and those components have value in the competitive manufacturing dairy market. That competitive value of milk is the base price from which Class I values are determined. Class I markets have their own pricing dynamics unique to that market and what the FMMO does is establish a differential value for Class I based on the competitive value of milk for manufacturing. The milk components are relevant in the manufacturing of dairy products and the levels need to be updated to reflect the higher component levels in the milk. This increased value must then be recognized in the base competitive value the FMMOs use to establish the Class I value.

Proposal 3 is to eliminate 500-pound cheddar barrels from the Class III pricing formula. MPC was already in support of this proposal prior to the hearing but had that support solidified when we considered the compelling testimony of Mr. Paul Bauer the CEO of Ellsworth Cooperative Creamery of Ellsworth, Wisconsin. Ellsworth makes barrel cheese and, in his testimony, he was adamant that having a separate barrel calculation in the Class III formula was distorting to the price discovery mechanism and needed to be eliminated. We found his argument compelling. We did appreciate the effort by Dr. Bozic to propose a "natural outgrowth" idea of adjusting the weight of barrels in the survey by collecting more price and volume data from cheddar cheesemakers but eliminating the barrels from the formula all together is the best option in our view.

Proposal 4 by the American Farm Bureau to add 640-pound blocks is interesting, but it seems from testimony that 640-pound blocks are essentially priced off of the 40-block price and therefore if barrels are eliminated, there is no need to open the door for more complication by adding 640-pound barrels.

Proposal 5 by the AFB is to add unsalted butter to the Class IV formula. Here we were persuaded by the bulk butter makers that unsalted butter is not the standard commodity product that salted butter is and no change to the existing butter product in the formula is warranted at this time.

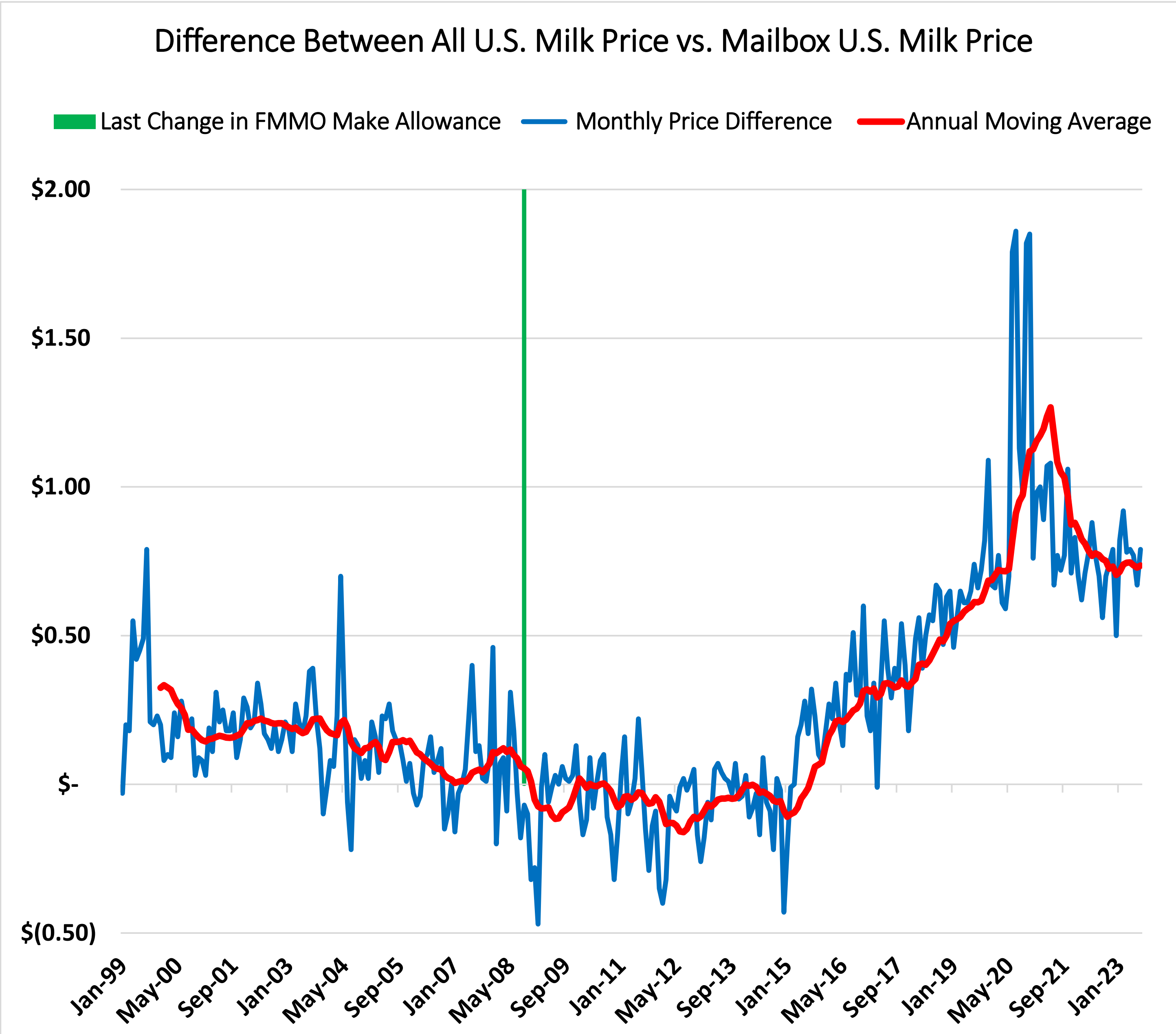
Proposal 6 by the California Dairy Campaign to add mozzarella as a product category for the discovery of price in the Class III formula is well intentioned, but significantly misses the mark as a viable proposal for consideration. The testimony we heard about the variations in mozzarella cheese packaging sizes and the lack of a standardized and recognized yield and manufacturing cost for mozzarella make this proposal non-viable at this time.

Proposal 7 by NMPF to update the make allowance factors in the Class III and IV formulas is a balanced approach given the obvious increases in the basic costs of labor and energy that have occurred since these factors were last adjusted in 2008. We appreciate and support NMPF's adjustments, recognizing that NMPF represents the vast majority of producer-owned cooperatives who themselves own and operate dairy manufacturing plants of all of the dairy products used in the Class III and IV formulas.

We have seen the reports produced by Dr. Stephenson and find them interesting. Obviously, those reports have the limitation of being voluntary and unaudited. The manufacturing cost surveys that were done by the state of California for their milk order are often held up as a model for the FMMO to follow. We have a lot of experience with the California system. And even in California, the manufacturing cost studies informed decision making, but did not dictate specific outcomes. Our experience with California and our observations today about manufacturing cost studies that may be done by USDA in the future is there needs to be a lot of transparency about how the studies allocate costs within plants that make multiple products, some of which are not the products that are part of the National Dairy Products Sales Report

(NDPSR) that establishes the product values in the FMMO formulas. The main reason these studies cannot dictate make allowance outcomes, is that the purpose of the exercise, is to establish a competitive value for milk and isolating only those products and costs that are associated with the NDPSR reportable products for consideration of setting make allowances in the formula would miss out on evaluating the totality of manufacturing enterprise. As has been said in this hearing, setting make allowances and other parts of the Class III and IV formulas is as much art as it is science. We think that comparing a couple of long running data sets USDA compiles can help provide context and direction for what level of adjustments should be made in the Class III and IV formulas.

Here is a comparison of the difference between the national All-Milk price and the national Mailbox milk price for all the months since the beginning of Federal Order reform in 1999. This comparison between the gross milk price paid to producers before deductions (the All-Milk price) and what they get in their mailbox after deductions (the mailbox price) does experience some spikes in the early 2000s and then noticeably narrows after the make allowance adjustment in 2008. It stays stable with mailbox prices even exceeding the All-Milk price for significant periods up until 2015. This data seems consistent with testimony we have heard in this hearing that the make allowance granted in 2008 was more than adequate to cover the costs of many manufacturing plants. The gap then begins to widen in 2015 and 2016. And then moves up steadily in 2017 and beyond, indicating greater milk check deductions, possibly to cover lower returns to manufacturing assets. The gap spikes in the pandemic era and then returns back to a high, but more consistent level with the immediate pre-pandemic period. We believe it is no accident that calls in the industry for changes to make allowances have intensified since 2017. We understand this and support changes to the make allowance. The question is how much change is appropriate? NMPF is proposing about a 55-cent adjustment in both Class III and Class IV make allowances. It looks from the data that if a 55-cent adjustment is made and it flows through to the mailbox price, as this chart indicates it might, that adjustment will definitely bring the gap between the all-milk price and the mailbox price back down to a more historically normal range. There is a commitment by NMPF to improve the manufacturing cost and yield data collection. But for now, the make allowance adjustments NMPF has proposed are very reasonable and defensible and MPC supports them.



As for proposals 8 and 9 we strongly oppose these nearly identical make allowance adjustment proposals by the Wisconsin Cheesemakers and the International Dairy Foods Association. As we have stated earlier, the cost surveys should be considered, but the objective here is to discover a minimum national value for milk used in Class III and IV manufacturing. The limitations of using a product value formula, as opposed to a direct survey of prices paid for milk, is that every manufacturing plant is different. The competitive environment for each plant is different. Manufacturing cost studies, even if audited and mandatory, can only tell you so much. There is a judgment call AMS must make when they establish a specific make allowance. As we see in the comparison chart between the US All-milk price and the national Mailbox milk price, there is room to adjust, but the magnitude of change contained in proposals 8 and 9 is way too large and should be rejected.

Proposal 10 by Select Milk Producers seeks to change the butterfat recovery percentage from 90 percent to 93 percent. While we are certain that most cheddar cheese plants capture more than 90 percent of the butterfat into the cheese, the current Class III formula does value the 10 percent of the butterfat that the formula assumes does not make it into the cheese at essentially the full Class IV butterfat value. Therefore, all of the butterfat in Class III is priced at a market value and until there is more and better information, including industry discussion on the mechanics of the Class III formula, we think the current Class III formula should remain in place.

Proposal 11 by Select Milk Producers seeks to change the farm-to-plant shrink factors in the formulas. We think this issue has merit for discussion in the future, but for this hearing we do not support this change.

Proposal 12 by Select Milk Producers seeks to update the nonfat solids factor in the Class IV formula by explicitly considering the contribution of buttermilk solids to the product value portion of the formula. We agree with Select that the contribution of buttermilk solids is meaningful and should be added into the Class IV formula at the next opportunity where the Class IV formula is part of a hearing call. But for this hearing, NMPF made adjustment proposals based on an assumption that the yields in the Class III and IV formulas would not be changed at this time. Select's proposal 12 would be a major change to the Class IV yield with substantial impacts on the net Class IV price. While we think this item deserves serious consideration and industry discussion in the future, we do not support making this change at this time.

Proposal 13 by NMPF seeks to return the base Class I milk price factor to using the "higher of" Class III or Class IV as was in place prior to May of 2019. Milk Producers Council strongly supports this proposal. Associating milk with the Federal Order is essentially a voluntary decision for all milk that is not Class I. That decision to associate with the order is made after the month is over, when prices are known. Essentially affiliating with the order has to be incentivized in close to real time. With this reality, it is absolutely critical that the structure of Class I pricing formula results in Class I being the highest class price most, if not all the time. Under a "higher of" Class I base price formulation, that reality is embedded into the structure of the pricing formula. Yes, there are months when the increase in either Class III or Class IV might be dramatic, and for that month surpass the advanced Class I price, but with a "higher of" Class I structure, the next month the Class I prices will catch up. Under the current "average of plus 74 cents" we are discovering periods of time where Class I prices are in misalignment with one or the other of the manufacturing classes for extended periods of time. This undermines the integrity of the whole premise of price alignment in the FMMO program and must be changed to assure the long-term success of the system.

Proposals 14 and 15 by IDFA and the Milk Innovation Group try to preserve the "average of" announced Class I base price by proposing a mechanism to change the adjuster over time to make up for the negative difference between what a "higher of" price would generate and what the "average of" mechanism generated. What these proposals fail to recognize is the damage that is done to the entire structure of the FMMO system when there is a misalignment of prices between Class I and the other classes. Milk Producers Council is a strong supporter of the FMMO system, and we see these proposals as undermining the ability to correctly discover the market value of milk and then translate that value into a properly aligned Class I price in real time.

Proposals 16 by Edge Dairy Farmer Cooperative wants to change the Class I base price by tying it to Class III alone, with an adjuster that would take years to make up for any negative difference this method would have from returning to the "higher of." It would also eliminate advance pricing for Class I. The basing of Class I on Class III alone is an even bigger step backwards than proposals 14 and 15 and creates the opportunity for major price misalignment between Class I and the other classes. Eliminating advanced pricing for Class I is also a terrible idea. The fact that Class I handlers know their milk price in advance and that they know that their competitors are all similarly regulated are key factors in preserving the integrity of the FMMO system.

Proposal 17 by Edge and Proposal 18 by the American Farm Bureau support returning to the "higher of" Class III or Class IV for establishing the base Class I price, but to eliminate advanced pricing for Class I and Class II. We have listened with interest to the extensive testimony in this hearing about hedging and what a wonderful thing it is. The fundamental reason the government is involved in regulating milk pricing is because of the inherent imbalance in market power between producers of fresh milk who have to sell their product every day to a buyer who does not have to buy every day. That inherent imbalance is mitigated by the FMMO system which discovers the market value of milk and then translates that value throughout the system. Hedging is just contracting or deregulation by another name. Milk Producers Council is unpersuaded that the balance of interests AMS must consider in making a decision on the various proposals that deal with the base Class I price necessitate adopting the radical approach of eliminating advanced pricing for Class I. Hedging tools should react to FMMO rules, not dictate those rules. The tail must not wag the dog.

Proposal 19 by National Milk Producers Federation is a comprehensive proposal to adjust Class I differentials for all 3,108 named counties in the continental U.S. Milk Producers Council is most familiar with the Class I differential updates proposed for California. We have read the testimony of the California Dairies representative on proposal 19 and find it to be an accurate reflection of our thoughts. Therefore, we fully support NMPF's proposal 19.

Proposal 20 by the Milk Innovation Group seeks to reduce the base Class I differential by $1.60 essentially decimating the FMMO Class I price surface. If MIG proposal 20 was adopted, it would substantially eliminate the incentive of milk to associate with the FMMO and because of that likely end producer support for the FMMO system. Therefore, MPC strongly opposes proposal 20.

Proposal 21 by the American Farm Bureau seeks to raise the Class II differential. AFB makes some important points to justify an increase in the Class II differential and MPC is supportive of Proposal 21.

In conclusion, the fundamental challenge facing dairy farms is that we produce a highly perishable product, that requires significant investment of capital and time to create, that must be sold every day to a buyer that does not need to buy every day. Convenient access to milk and dairy products at reasonable prices is in the public interest. The FMMO's role is to be a referee of the relationship between producer and processor. For this system to be successful the price regulation needs to be based on market values. For 85 years the FMMO system has successfully performed this role. It is time for some adjustments and updates to the basic parts of the formulas. It is not time for radical change. NMPF has pointed the way forward and Milk Producers Council strongly supports the entire NMPF package of proposals.

MPC thanks the Secretary and USDA AMS for calling this hearing and giving us the opportunity to share our views.