



CALIFORNIA DAIRY CAMPAIGN "DAIRYMEN WORKING FOR DAIRYMEN"

TESTIMONY

USDA PUBLIC FORUM ON BASIC FORMULA PRICE

JULY 29, 1996 MADISON, WISCONSIN Chairman Mr. Myron McKinley and members of the panel:

My name is Francis Pacheco. I am the general manager of the California Dairy Campaign, also known as CDC. CDC appreciates this opportunity to testify on the issues pertaining to the Federal Milk Marketing Order reform of the Basic Formula Price formula. The concepts presented today were unanimously approved by CDC's board of directors. The California Dairy Campaign has 255 members in our organization from all milk producing regions of the state.

CDC hopes that this forum results in improving the economic viability of this country's dairy producers. Under the current USDA milk pricing formula many of the dairy producers are going out of business due to raw milk being under valued. It is apparent that the Basic Formula Price (BFP) pricing system plays a significant role in determining dairy producer income.

This panel should observe all factors to determine the reasons why the exchanging of the Minnesota-Wisconsin pay price system for the BFP pay price system resulted in lower producer milk prices. There is a strong possibility that the problem with the BFP could have been brought about due to the increase in reliance of end product pricing to determine the value of producers' milk .

CDC is representing the views of dairy producers. It is important that this forum recognizes that there are different segments of the dairy industry; producer, processor and consumer. There is usually an inherent conflict of interest with dairymen and processors over the issues of milk prices and supply. Processors would like a large supply of milk which then lowers the producers price resulting in higher plant profits.

In the past, processors did not have to become market oriented because the government, Commodity Credit Corporation (CCC), would purchase the surplus which gave the wrong supply and demand signals. The CCC allowed dairy product reserves for consumers but negatively effected producer prices. When producers' milk prices would begin to rise the processors would purchase the surplus out of storage to sell on the market resulting in the lowering of producer milk prices. Without the availability of dairy products from surplus storage for the processing industry to manipulate the milk price, producers are experiencing an increase in their milk prices.

In the California state order milk prices are set using end product pricing formulas. End product pricing formulas alone do not find the true value of raw milk and give no incentive to move raw milk into the higher value products. This system does not take into consideration the value of milk due to competitive market forces. End product pricing allows processors to determine the milk price that they will pay for the raw milk without consideration of what products are needed in the market. Dairy product prices are established on the basis of limited trading by a limited number of purchasing companies. The results of the recent National Cheese Exchange study is a good example of this point. Another major issue is the setting of a make allowance level. Make allowances tend to become obsolete rapidly allowing for plant inefficiency and interfere with market signals. The California end product pricing system is an example of this point. California allowed plants to be profitable and expand processing of the lowest value dairy products regardless of market demands resulting in lower producer milk prices. Processors with a generous make allowance level use this margin to discount the product price to gain market share at the expense of producer pay prices.

The California milk prices paid to producers have been significantly lower than the Federal Order milk prices. The averaged difference in raw milk prices used for cheese manufacturing between California Class 4b and the Federal Order M&W/BFP in 1994 was \$1.01 per hundredweight (M&W = \$12.00 minus Class 4b = \$10.99) and in 1995 was \$0.63 per hundredweight (M&W = \$11.83 minus Class 4b = \$11.20).

The recent decision by USDA to create a new classification of milk, known as Class IIIA, has been to the detriment of producer's milk pay price. Processors wanted Class IIIa to compete with California's Class 4a. A survey done by the American Dairy Products Institute on domestic

sales of nonfat dry milk by end-use revealed that 68.5 percent of domestic powder in 1994 was used in the processing of dairy products. This information indicates that dairy producers have been cheated out of the true value of their raw milk because powdered milk was used to displace the higher valued raw milk for cheese, yogurt, and other dairy product processing. A system should be devised to compensate dairy producers for the loss in the raw milk's true value.

Make allowances give milk processors a consideration that milk producers due not receive. Make allowances assist the milk processors in covering the production costs of the plants, whereas, the milk producing segment of the industry receives no production consideration at all. A fair milk pricing system would give some type of production allowance consideration in determining the fair value of milk.

A milk pricing system based on futures contracts for raw milk, such as in the Coffee, Sugar and Cocoa Exchange, is not going to be a fair pricing system. This type of pricing system would be based on a relatively new and not yet proven milk contract system. There are not enough contracts traded on the exchange to inhibit the manipulation of the raw milk price producers would receive. This milk price system would have rapid price fluctuation since it is based on speculative and unstable market signals.

A competitive pay price, such as the competitive A/B price in the upper Midwest, would be a better price discovery method than end product pricing to establish the true value of raw milk. Competitive pay prices automatically reflect processing margins, so that the problems associated with maintaining accurate and up to date make allowance provisions are avoided. However, competitive pay pricing is not perfect because it does not establish the current value of raw milk in the market. A competitive pay price system requires a strong unregulated processor market to accurately determine the value of manufacture milk. This scenario is not readily available in today's marketplace.

A milk pricing system with a combination of a competitive A/B pricing and end product pricing that includes an adjuster for producer production cost would be the ideal milk pricing system to all segments of the dairy industry. A milk pricing system without a production cost adjustor would not allow a correlation between product prices and the increasing costs of feeds. This past year is an excellent example of this point. This type of price correcting mechanism could be very beneficial to averting potential supply problems that would cause radical price increases for consumers.

The dairy industry today is in uncharted waters with no dairy surplus in storage, and minimal government involvement allowing a free market type of environment to form. However, the current milk pricing policy and any type of milk pricing policy that does not consider producer costs will cause volatile changes in milk prices for producers and dairy product prices for consumers. An adjustor of producer costs should allow the increase in feed prices to be passed onto the market as soon as possible, so that producers would have a responsive milk pricing system. A pricing system with an adjustor for producer costs would sustain an adequate supply of milk for all uses, which will minimized negative consumer reactions to spikes in the price of dairy products.

The dairy producers across this country are experiencing severe economic conditions due to high production costs and the low milk prices that they receive. It is important that USDA maintain an adequate supply of fresh quality wholesome milk for consumers to purchase from the milk display case and for processors to manufacture dairy products for consumers' demands to ensure a healthy dairy industry. This forum today should realize the conditions dairy producers are facing and adopt the milk pricing system which returns a fair milk value to dairy producers.

On behalf of the California Dairy Campaign I would like to thank you again for this opportunity to present our viewpoints. I am willing to answer questions from the panel.