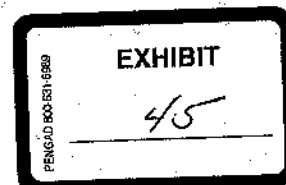


**TESTIMONY OF  
THE INTERNATIONAL DAIRY FOODS ASSOCIATION  
DECEMBER 2006 FEDERAL MILK ORDER HEARINGS  
DOCKET NO. AO-14-A76, et al.; DA-07-01**

This testimony is submitted on behalf of the International Dairy Foods Association (IDFA), a trade association representing manufacturers, marketers, distributors, and suppliers of fluid milk and related products, ice cream and frozen dairy deserts, and cheese. IDFA represents the nation's dairy manufacturing and marketing industries and their suppliers, with a membership of 530 companies representing a \$90-billion a year industry. IDFA is composed of three constituent organizations: the Milk Industry Foundation (MIF), the National Cheese Institute (NCI) and the International Ice Cream Association (IICA). IDFA's 220 dairy processing members run more than 600 plant operations, and range from large multi-national organizations to single-plant companies. Together they represent more than 85% of the milk, cultured products, cheese and frozen desserts produced and marketed in the United States.

As buyers and processors of milk, IDFA members have a critical interest in this hearing. Most of the milk bought and handled by IDFA members is regulated under the federal milk marketing orders ("FMMO") promulgated pursuant to the Agricultural Marketing Agreement Act of 1937 (the "AMAA").



I am Dr. Robert D. Yonkers, Chief Economist and Director of Policy Analysis at the International Dairy Foods Association ("IDFA"). I have held that position since June 1998. I hold a Ph.D. in Agricultural Economics from Texas A&M University (1989); a Masters degree in Dairy Science from Texas A&M (1981); and a Bachelor of Science degree in Dairy Production from Kansas State University (1979). I have been a member of the American Agricultural Economics Association since 1984.

Prior to taking my current position at IDFA, I was a tenured faculty member in the Department of Agricultural Economics and Rural Sociology at The Pennsylvania State University, where I was employed for nine years. At Penn State, I conducted research on the impacts of changing marketing conditions, alternative public policies, and emerging technologies on the dairy industry. In addition, I had statewide responsibilities to develop and deliver extension materials and programs on topics related to dairy marketing and policy. I have written and spoken extensively on economic issues related to the dairy industry, and I have prepared and delivered expert witness testimony to state legislatures and to Congress.

These hearings were called to consider proposals contained in a petition from National Milk Producers Federation (petitioners) to change the Class I and II price formulas used in all Federal Milk Marketing Orders

(FMMOs). IDFA opposes all five proposals contained in the hearing notice, and in addition opposes their consideration on an emergency basis. For the reasons I am about to explain:

1. There is no need to make these changes to ensure orderly marketing or a sufficient quantity of pure and wholesome milk to meet current (or projected) needs;
2. Making the proposed changes would lead to disorderly marketing;
3. Data used by proponents of these changes do not address the relevant considerations, and are in any case seriously flawed, and in many instances, self contradictory.

Before addressing these issues in detail, I would first like to note our strong objection to the short notice provided for this hearing. Class I pricing is the most fundamental aspect of federal order regulation. Past considerations, such as those undertaken during order reform, have involved detailed and careful analyses, including analyses of the regional impacts of Class I pricing. The hurried nature of these hearings has resulted in superficial presentations and the use of surrogate (and as noted, often flawed) data even with respect to those factors that the proponents claim are relevant to the inquiry.

Earlier this year, USDA suspended for several months its consideration of updating the Class III and IV make allowances to await the development of what it believed would be more reliable and appropriate data than it had received when those make allowance hearings had first been held in January 2006. We believe that USDA must conclude either that the proposals in this hearing should be denied or that a suspension of consideration of the proposals should occur in order to permit appropriate data to be developed.

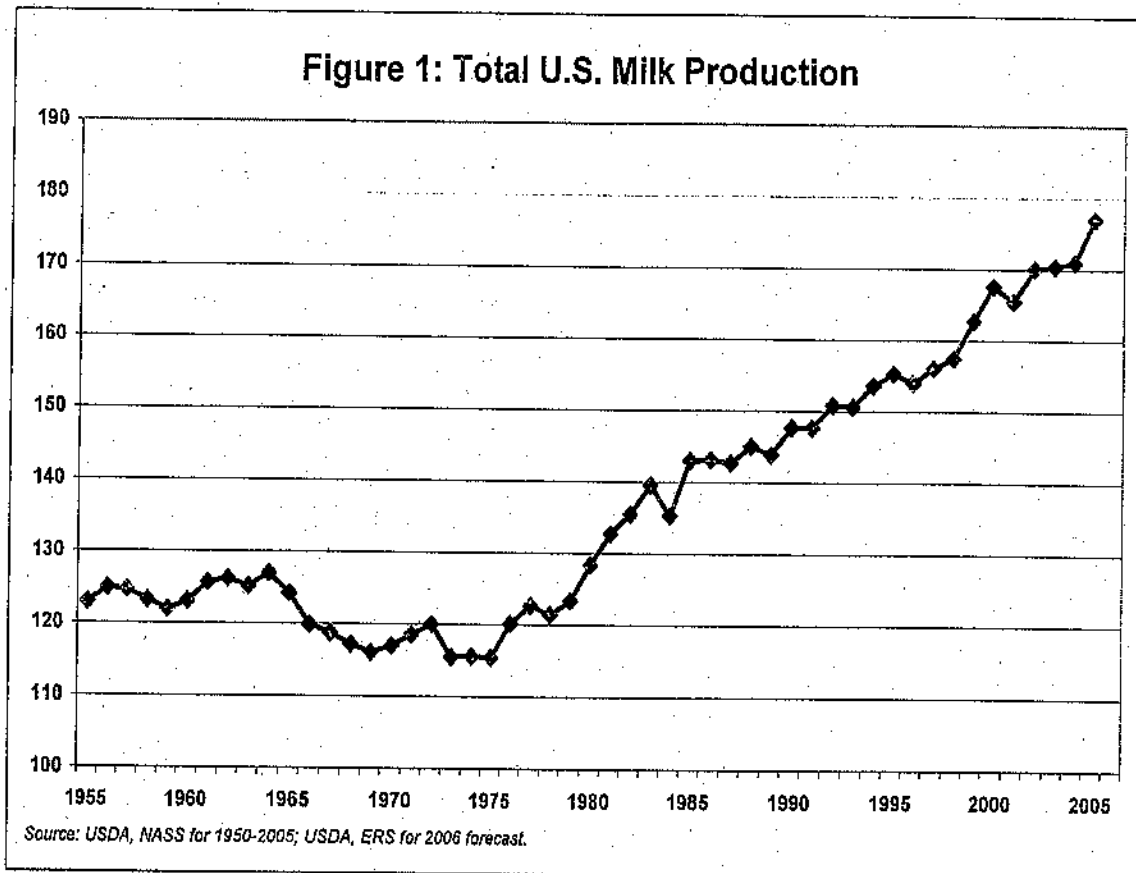
There is no need to make these changes to ensure orderly marketing or a sufficient quantity of pure and wholesome milk to meet current (or projected) needs. I would have assumed that everyone, including the proponents, would have recognized that the touchstone of the inquiry here is the adequacy of the milk supply to meet Class I needs. This is of course a critical factor under the AMAA, and was by far the most important factor to USDA when it last held a hearing to consider raising Class I and II prices, in 1998. As I will discuss in more detail below, USDA at that time rejected a proposed floor price that would have had the effect of raising Class I prices by \$1.05 per cwt, principally because there was no evidence of a shortage of milk for Class I needs.

More recently, in a January 23, 2003 letter to Congressman Blunt, and

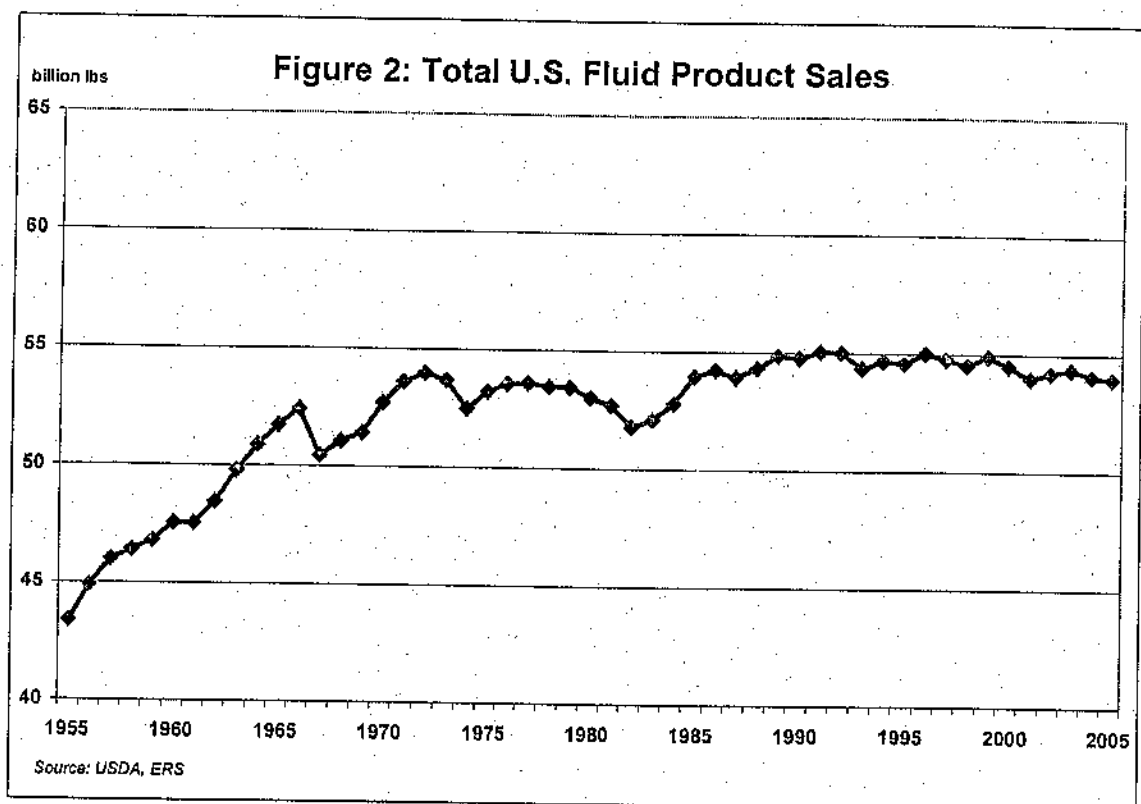
a January 21, 2003 letter to Congressman Sherwood, explaining why USDA would not call a hearing to consider a "drought adjustment surcharge" on Class I and Class II prices, Under Secretary Hawks listed the first objective of the FMMO program as "to assure an adequate supply of milk for the fluid market..." I would ask that these letters be introduced as Exhibits \_\_\_ and \_\_\_.

Remarkably, the proponents do not even attempt to address this factor, claiming it irrelevant. I find that attitude baffling in light of the AMAA standard and past USDA practice.

The facts are clear, and telling. The U.S. milk supply has been, and will continue to be, adequate to meet all market needs for milk, and is certainly much more than adequate to meet all needs of the fluid market -- the touchstone under the AMAA. Total U.S. milk production has grown dramatically in the past 30 years. In 1975, total U.S. milk production was 115.4 billion pounds. This has grown to 177.0 billion pounds in 2005, and is forecast by USDA to increase another 4.9 billion pounds in 2006 to 181.9 billion pounds (see figure 1). This increase of 57.6 percent over the past 31 years has only been due to increases in consumer demand for farm milk for the processing and manufacture of milk and dairy products.



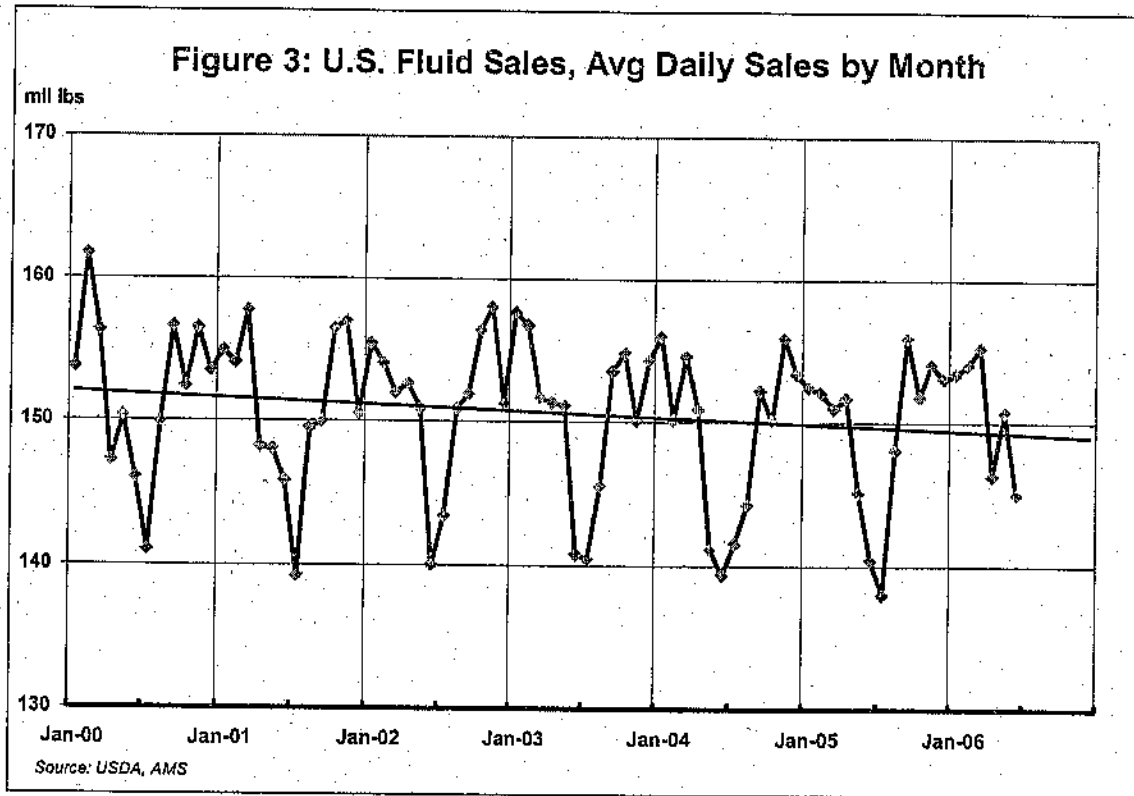
However, little of this increased farm milk production has been needed to serve the need for fluid milk products. While U.S. milk production grew by 61.6 billion pounds between 1975 and 2005, total U.S. fluid product sales only grew by 800 million pounds (0.8 billion pounds). U.S. total fluid product sales were 53.2 billion pounds in 1975, and reached a record high of 55.1 billion pounds in 1991. Since then, total fluid product sales have been on a slight downward trend, and were only 54.0 billion pounds in 2005.



As these very different trends in farm milk production and fluid product sales demonstrate, there is clearly no lack of farm milk available to serve the declining fluid sales. Indeed, it is more than a little ironic that the proponents would choose to burden with sharply higher prices the one segment of the dairy industry (fluid milk) that has experienced for many years now steady declines on a per capita basis.

The most recent trend in total U.S. fluid product sales can also be seen in the use of monthly data published by USDA's Agricultural Marketing Service. Adjusted to average daily volumes, total fluid sales have trended downward since the implementation of federal order reform in 2000 (see

figure 3).



Nor can it be argued that, for whatever reason, this increase in milk production has not, nor will continue to be, available to all dairy processors. Several IDFA members, representing significant Class I and II processing capacity in many different areas of the country, have presented testimony regarding their ability to procure milk for these class uses with ease.

In addition, USDA itself in recent years has repeatedly and consistently found that the supply of milk in the U.S. is more than adequate



to meet the needs of the Class I market -- and that this dictated that Class I prices not be raised.

In its June 1998 decision resulting from a hearing to consider a proposal to floor the Class I and II prices in all FMMOs, USDA addressed a proposal by NMPF members that in effect would have increased the Class I differential by \$1.05 (see 63 FR 32147). USDA noted:

"Despite a 46-percent reduction in the number of U.S. dairy farms from 1988 through 1997, milk production increased 8 percent. The data contained in the record of the public hearing in this proceeding provide no basis to expect that an adequate supply of milk for fluid use will not be available nationwide. Therefore, the record does not support adopting the proposal, which would encourage more milk production." Fed Reg Vol 63 No 113 page 32149.

And later;

"The petition for flooring the BFP is denied because there is no evidence of a national milk shortage, either for all uses or for fluid uses." Fed Reg Vol 63 No 113 page 32150.

And still later:

"The facts clearly demonstrate that the proposed floor is not required by supply and demand conditions." Fed Reg Vol 63 No 113 page

32150.

The only difference between the facts at the time of that decision and now is that milk production has continued to grow at an even faster rate, and fluid milk product sales have continued to trend downward.

Nor did that emphasis change in order reform. USDA in both the January 1998 proposed rule and the April 1999 proposed rule following order reform emphasized the need to assess whether the Class I price will "generate sufficient revenue to bring forth an adequate milk supply." 63 FR 4912; 64 FR 16115. That goal clearly does not require raising Class I prices.

It is perhaps understandable that the proponents here choose to act as if the adequacy of the milk supply is an irrelevant consideration, given that the facts on the subject point so clearly toward the denial of their proposal.

The NMPF proposal simply ignores the most important criterion for Class I pricing, namely, the adequacy of the milk supply. This is particularly ironic since NMPF is itself engaged in marketplace efforts that seek to achieve the opposite goal. They are operating a program whose very purpose is to reduce the supply of milk in the U.S. NMPF's Cooperatives Working Together (CWT) effort collects, on a voluntary basis, 10 cents per hundredweight of milk marketed by participating producers and cooperatives. The funds collected are then used in various ways to reduce

the supply of farm milk and dairy products available to the U.S. market. NMPF claims that its CWT program has reduced the national milk supply by 3.3 billion pounds since 2003, and effective July 1, 2006, doubled the per hundredweight assessment for the CWT program (see Exhibit 8).

IDFA also notes there are currently FMMO regulations other than minimum pricing which address the factors which petitioners claim require changes in the minimum Class I and II prices. In fact, several of these regulations are in the process of being changed in some or all FMMOs as we sit at this hearing.

USDA has announced a tentative final decision to update the factors in the class price formulas which reflect costs of manufacturing Class III and IV products, a decision which USDA expects to be implemented in February 2007 or soon thereafter. This change was announced by USDA to do what NMPF is asking for now: update the factor representing the costs of processing for plants manufacturing Class III and IV products. NMPF asserts that the Class I price needs to be changed to address balancing costs, but in its January 2005 final decision rejecting a proposal to cover costs of balancing in the Northeast marketing area with the use of marketwide service payments, USDA noted:

"Opponents correctly note that the costs of balancing have already been considered and are accounted for in the Class IV product-price formula make allowance used in all Federal milk marketing orders for establishing the Class IV milk price." Fed Reg Vol 70 No 19 page 4951.

In addition, USDA on December 1, 2006 implemented a decision for the Appalachian and Southeast marketing areas to address the costs of moving milk to those markets for Class I use. Other witnesses discussed the specifics of the changes. I will simply observe that the adoption of the proposals being considered at this hearing would duplicate the adjustments made in those marketing areas. Furthermore, transportation credits are a better way to address the problem, given that the one providing the transportation service gets paid for it, as opposed to changing Class I differentials and paying money to those providing no services of any kind. A similar set of regulations exists in the Upper Midwest marketing area to move milk from supply plants to pool plants.

USDA also, several times since federal order reform, has held hearings and adopted changes in some marketing areas to limit the pooling of milk. There have been two hearings to consider such proposals with decisions in each of the following marketing areas; Upper Midwest, Central

and Mideast. The most recent of these decisions were only implemented on December 1, 2006. One reason these decisions were implemented was to address problems with depooling, which in some months led to significant volumes not being pooled on the orders due to adverse class price relationships, with the resulting decrease in the volume of milk shipped to Class I plants in order to remain in the pool.

**Making the proposed changes would lead to disorderly marketing.** The preliminary impact analysis conducted by USDA and published as part of the notice for this hearing leads to the conclusion that there is no market problem, and that the proposals would create disorderly marketing.

The baseline analysis provided by USDA clearly demonstrates that U.S. milk production will be more than adequate to meet current, as well as future, demands for milk and dairy products. Total federal order marketings in the baseline increase by over 9.6 billion pounds in the next 9 years (the same analysis could not be made for total U.S. marketings, due to the lack of detailed, year-by-year data like that provided for federal order marketings in the "Appendix to Preliminary Analysis for Hearing Concerning Class I and II price formulas"). Meanwhile, the same baseline shows total federal order

Class I marketings increase by only 147 million pounds (0.147 billion pounds) during the same 9 year period.

Milk production growth thus far exceeds the needs of the Class I market. In fact, the baseline estimate of an increase in federal order Class I marketings is an optimistic deviation from the trend since 1991 of a decline in total U.S. fluid product sales as reported by USDA's Economic Research Service, as well as the more recent trend in estimated total U.S. fluid sales published by USDA's Agricultural Marketing Service.

In addition to the baseline analysis clearly demonstrating that milk production will be more than adequate to meet fluid product needs for at least the next nine years, the analysis of the proposals by USDA clearly shows how it promotes disorderly marketing. Adoption of the proposals would decrease federal order Class I use by 616 million pounds over the next 9 years, more than wiping out the meager increase forecast by the baseline without adopting the proposals. Total U.S. Class I use would decline even more, losing 747 million pounds.

At the same time, the impact analysis also shows that total federal order milk marketings would increase by 1,294 million pounds as a result of adopting the proposals. Note this growth is on top of the baseline's forecast growth of 9,600 million pounds. The impact on total U.S. milk production

is even greater, with adoption of the proposals leading to an increase of 2,043 million pounds above the baseline.

**This means the net impact of adopting the proposals is to reduce total U.S. Class I use by 747 million pounds from the baseline, while at the same time increasing total U.S. marketings by 2,043 million pounds.** The result is an increase in the use of milk in all manufactured dairy productions of the sum of these two figures, or 2,790 million pounds more than the baseline increase.

As USDA's impact analysis clearly shows, the sum of the reduced Class I use and the additional farm milk marketings end up being used in manufactured dairy products. This, in turn, reduces the market prices for butter, nonfat dry milk, cheese and dry whey such that not only are Class III and IV minimum prices lower if the proposals are adopted, but so are Class II prices. The latter is certainly disorderly marketing, if as NMPF claims the changes are necessary to increase the Class II price to ensure an adequate supply of milk for Class II use.

Looking at this another way, adoption of these proposals will force NMPF to increase the level of activity under the Cooperatives Working Together program to remove an additional 2.79 billion pounds of milk above what they planned to remove over the next 9 years in order to meet their

target of maintaining the wholesale butter price at \$1.30 or above and the wholesale price of cheddar cheese at \$1.40 or above (even assuming this is a legitimate effort).

**The disparity of regional impact.** One notable feature missing from USDA's impact analysis and, presumably, its baseline model period, is the ability to analyze the impacts of the NMPF proposal on a marketing area by marketing area basis. Certainly, this information is critical for producers who might have to decide whether to vote for or against the orders in a referendum should the proposals be adopted.

USDA has in fact consistently noted the disparate regional impacts as justification for rejecting previous calls for a national change in the Class I and II price calculations. When it acted in 1998 to reject the \$1.05 Class I price increase reflected by the price floor proposal, USDA looked not only to the fact that the milk supply was more than adequate, as discussed above, but the disparity of regional impact:

“The proposed floor under Class I and II prices would have unequal effects on farm-level milk prices unrelated to the financial need of the farmers affected. The benefit of the proposed floor to a producer would depend on the proportion of Class I and II milk used in the order in which the producer’s milk is pooled. Thus, a producer whose



milk is pooled under a marketing order with a relatively high 80 percent Class I and Class II use would get 80 percent of the projected \$1.05 difference between the proposed floored price and the projected BFP for the last half of 1998 and early 1999, or \$0.84 per cwt. On the other hand, producers in marketing order areas with a relatively low 20 percent Class I and Class II use would receive the benefit of only \$0.21 of the \$1.05 increase in class prices. Producers in high Class I use areas already receive higher blend prices for their milk than producers in areas with lower levels of Class I use, and the effects of the price floor proposal would widen the differences between such areas." Fed Reg Vol 63 No 113 page 32150.

This same point was made by Undersecretary Hawks in the January 2003 letters that I mentioned earlier:

"Adding a surcharge to Class I and Class II prices would provide substantially different benefits to farmers depending upon their location. For example, the farmers in the Florida FMMO, which has higher Class I utilization of about 90 percent, would benefit greatly from such a surcharge for milk used in Class I products. However, there would be substantially less benefit to producers marketing milk

in the Upper Midwest FMMO where only about 20 percent of the milk is used in Class I."

In its 1998 decision rejecting the call for a price floor that would have increased Class I and Class II prices by \$1.05 per cwt, USDA concluded that dairy producers in marketing areas with low Class I and Class II utilization would experience depressed prices for their milk, precisely the concern expressed in this hearing by dairy producers and organizations in the midwest and upper midwest:

"The higher class I and II prices would also increase milk production and reduce fluid milk consumption, which would lower prices for milk used in manufactured dairy products. Lower prices for these other classes of milk would be even more detrimental to producers in low Class I and II utilization markets." Fed Reg Vol 63 No 113 page 32150.

The regional impacts are further exacerbated when the impacts of another federal dairy program, the Milk Income Loss Contract (MILC) program, are accounted for. As USDA's impact analysis notes, MILC payments to dairy producers nationwide decrease by \$82 million in 2007 if these proposals are adopted. Producers located in marketing areas with smaller average milk marketings per farm, such as the Upper Midwest,

Central, Mideast, and Northeast, would bear the brunt of lower MILC payments significantly more than marketing areas where average milk marketings per farm are greater like the Southwest and Arizona areas. While the USDA impact analysis assumes the MILC program payment rate is zero beyond 2007, changes in the majority in both houses of Congress, with the resulting changes in both chamber and committee leadership, could result in the extension of the current payment rate of 34% or even higher.

Even without the extension of the MILC program's non-zero payment rate, USDA's impact analysis shows that government costs increase above the baseline in each of the next 9 years due to increased purchases of dairy products under the Milk Price Support Program. How can it not be considered disorderly marketing to adopt changes designed to increase the Class I and II prices which lead to less Class I use, lower Class II milk prices, lower Class III milk prices, lower Class IV milk prices, and greater use of farm milk in manufactured dairy products, at least some of which must then be purchased by the government to maintain higher farm prices?

Dr. Brian Gould of the University of Wisconsin has already testified regarding the widely disparate impacts these proposals would have on different regions of the country. Dr. Knutson has quantified the negative

impacts of the proposals to Upper Midwest dairy producers, and I will not repeat that testimony here.

And what do the rest of us in the United States get if the NMPF proposals to change the Class I and II prices were adopted? In addition to the increased cost to taxpayers from increased purchases of manufactured dairy products under the Milk Price Support Program, consumers get to pay more for fluid milk products. USDA's impact analysis estimates the increase to be about 5.5 cents per gallon. However, the impact analysis documentation notes that retail fluid milk prices are not projected in the model, so the impact could even be higher. **So, the rest of us get to pay more for fluid milk and see more of our tax dollars spent on buying manufactured dairy products the marketplace does not want, notwithstanding a baseline analysis of total federal order marketings increasing an average of about 1 billion pounds per year, which drastically exceeds the need for less than 20 million additional pounds of federal order Class I marketings per year.**

**The process followed here is flawed.** This hearing was called with less than three weeks notice, and only the NMPF proposal is being considered. Contrast this with the current process underway to consider changes to the Class III and IV price formulas. On June 28, 2006, USDA

announced it was seeking industry proposals for changes to the Class III and IV price formulas, and allowed more than 90 days (until September 30, 2006) for industry participants to discuss various alternatives and conduct analysis prior to the submission of proposals. USDA then for the first time conducted a pre-hearing public information workshop to further clarify the intent and specifics of the proposals submitted. This process for Class III and IV price formulas changes should have been, at the very least, adopted before any hearing to consider changes to the Class I and II price formulas.

In addition, this short notice did not allow for more deliberate and careful analysis of the supply and demand situation in the dairy markets. The last time USDA considered such changes was during the federal order reform process. While Congress did grant USDA the authority to use informal rulemaking for that process, USDA set out on a very public path to ensure that all relevant proposals were considered.

In addition, USDA ensured that all proposals would be carefully and deliberately analyzed. This was accomplished by the creation of several study committees, both within and outside of USDA, plus USDA funding of research specifically designed to provide critical analysis of the full market supply and demand factors relevant to consideration of the class price formulas. None of this is happening here.

**The premise of the proponents' request is flawed.** Proponents justify their proposals with the premise that costs have increased with respect to three specific cost items, in excess of the costs of those items identified by USDA in its January 1998 proposed rule for federal order reform (Exhibit 9). However, that decision discussed 7 options for setting minimum Class I prices. The costs items upon which proponents purport to rely were only discussed in one of those 7 options. And USDA picked only one of the 7 options as the preferred option, and it was not the one in which these cost items are discussed. Yet the proponents here purport to use that discussion as the basis for justification for increasing the Class I price.

USDA in 1998 made clear that:

"At this time Option 1B is preferred for several reasons. First, this option is based on model results that reflects the best available estimates of least cost assembly and shipment of milk and dairy products to meet all dairy product demands. By promoting market efficiencies, it would be expected to result in the most preferable allocation of resources over time. Option 1B would move the dairy industry into a more market-determined pricing system. By lowering differentials, marketing conditions will have a greater impact on actual Class I prices in the form of higher prices that are provided to

those producers who service the Class I market. In this way, the revenue necessary to obtain milk for fluid use may be minimized since the Class I value is not shared marketwide with those producers that do not service the fluid market." Fed Reg Vol 63 No 20 pages 4914-5.

Rather than look to what USDA actually concluded in 1998, proponents build their case for change proposed at this hearing on the justification for Option 1A as discussed in that 1998 recommended decision. But as noted, Option 1A was rejected in the 1998 proposed rule, in lieu of Option 1B. Nor was that justification later accepted in the 1999 final decision, which concluded that the Class I differential should not be based upon "the additional value of Class I milk in the most surplus area," but rather a level "that will generate sufficient revenue to bring forth an adequate milk supply." 64 FR 16115.

As we have seen, that goal is certainly achieved by the current Class I differentials.

It was only by an act of Congress, not the careful and deliberate analysis conducted over a three year period by USDA that forced the dairy industry to adopt modified Option 1A with a minimum Class I differential of \$1.60.

USDA is under no obligation to assess Class I differentials now using an approach that USDA rejected in both 1998 and 1999. Congress certainly has never mandated that it do so. We are not suggesting that USDA at this hearing reverse the higher Class I differentials imposed by that legislation. But Congress never endorsed, much less imposed, a specific methodology for determining Class I differentials. USDA must apply AMAA standards in determining whether there is any justification for increasing Class I prices, in a manner consistent with its past practice.

I note that several witnesses have testified to the belief that if USDA decided to update the make allowances used in Class III and IV price formulas then it has the obligation to update the Class I and II price formulas. Nothing could be further from the truth. Manufacturers of Class III and IV products have a noose placed on their ability to cover non-milk costs in the make allowance - the margin between their output price and cost of farm milk is fixed. When costs rise, there is absolutely no recourse for those manufacturers except to process milk at a loss or to exit the industry.

On the other hand, several witnesses have claimed that this same conundrum does not exist for Class I and II processors that they are fully able to pass along higher costs to customers while holding their farm milk suppliers free from harm. This is in and of itself a naive and incorrect view,



as several others have testified that the harm in higher prices comes in the form of reduced demand for milk and dairy products, something everyone at every stage of the dairy industry should avoid creating incentives for.

But of more direct relevance here, proponent's witnesses fail to recognize that the fact that the pricing of Class I and II products is not controlled by a make allowance formula applies equally to dairy producers. There is no make allowance that fixes the margin between their output price and input costs. In fact, the lower milk prices in 2006 cited by many are a direct result from higher farm margins in 2004 and 2005 due to the highest two year period of farm milk prices on record. Clearly, if dairy producers had been subject to a make allowance, forcing their input costs to increase penny for penny with every increase in farm milk prices, there would never have been a surge in milk production leading to the lower prices in 2006.

**The proponents' data is very flawed.** Even if cost data were properly considered, the proponents' data is very flawed. In the recent Class III and IV make allowance decision; USDA rejected the use of its own RBCS survey data, notwithstanding its long pedigree and USDA's prior reliance upon that very data for purposes of setting make allowances. USDA did so because it deemed that data insufficiently reliable. Given the standard set in that hearing, it is very difficult to see how USDA could rely

upon the proponents' data as a basis for changing Class I prices.

Proponents conduct no analysis of how the vast structural changes which occurred between the 1996-97 period on which USDA based its analysis of the justification for Option 1A (which it rejected) and today impact the market. Merely updating information which is nearly a decade old, and as I will show in some cases is 30 years old, ignores industry adjustments to changes in relative costs, changes in technology, and changes in underlying economic forces of the marketplace.

Moreover, proponents have conducted no study of any of the actual costs they purport have increased substantially since the time of the 1998 federal order decision. They provided no analysis of the difference in costs between actual Grade A farm operations and Grade B farm operations. They provided no analysis of the costs of balancing in the marketplace borne by firms with those costs, nor any analysis of the actual increase in transportation costs due to longer hauls between farms and Class I plants. Finally, they conduct no analysis of the changes in marketplace premiums for class I milk which could identify other explanations for increases in some time periods and decreases in others, as well as changes in some marketing areas and the lack of any change in others.

Thus, even if one were to ignore the salient considerations of the adequacy of the milk supply, and the regional disparity of the impact of the proposals, and accept the relevance of the factors upon which the proponents rely, the proposals should be rejected.

**Grade A versus Grade B farms.** Let's begin with a look at the difference in costs of producing milk on a Grade A versus a Grade B dairy farm operation. First of all, a key justification for federal order price regulation was to encourage conversion of Grade B farm operations to Grade A farm operations. That aspect has been wildly successful; today, USDA reports that 98 of U.S. milk production comes from Grade A farm operations --vastly in excess of the amount needed to service the Class I market. (USDA, NASS, Milk Production, Disposition and Income). There is no evidence whatsoever of a need to provide any financial incentives or rewards for becoming, or maintaining, Grade A status.

In fact the only actual data related to the cost differences between Grade A and Grade B farm operations was presented by Mr. Tonak, which show that difference to be far lower than the 40 cents per cwt proponents assume is the beginning point. This would support a significant decrease in the Class I differential.

The proponents provide no basis upon which USDA could reach a conclusion as to the relative cost of being a Grade A versus a Grade B farm. The 1998 USDA federal order reform decision did cite an estimate of a 40 cent per hundredweight difference, but did not cite a useful source for that estimate. The most recent publication of research into the actual cost differences between actual Grade A and Grade B dairy farm operations was published almost thirty years ago, by Frank, Peterson and Hughes in April 1977, based on actual farm data from 1974-75 ("Class I Differential: Cost of Production Justification. Gary G. Frank, G.A. Peterson and Harlan Hughes, in Economic Issues; Department of Agricultural Economics, College of Agricultural and Life Sciences, University of Wisconsin-Madison, Number 8, April 1977.). Interestingly, while the 1998 USDA decision cites several fixed factors of production expected to contributed to the difference ("A Grade A farm requires an approved water system (typically one of the greatest conversion expenses), specific facility construction and plumbing requirements, certain specifications on the appearance of the facilities, and specific equipment."), Frank, et al actually noted that "The average producer of fluid eligible milk had \$17,892 more invested per farm in 1974 and \$18,477 in 1975 than the average manufacturing grade milk producer. On a per hundredweight of milk sold, this difference was not statistically

significant." Therefore, the greatest expenses noted by USDA were found to be not statistically different between fluid eligible and manufacturing grade milk producers.

Of equal importance, the proponents purported "updating" of the alleged forty cent spread between the costs of maintaining a Grade A versus a Grade B ignores the fact that the standards for producing Grade B versus Grade A milk have narrowed over time. There is no basis for anyone to make assertions as to the purported cost difference between being a Grade A farm and a Grade B farm without bothering to look at what the current standards are for Grade A and Grade B farms. Yet that is what proponents have done.

In addition, the proponents have conducted no study of the actual costs associated with maintaining Grade A status, but purport to apply as a surrogate the changes in some of the on farm costs of production over an 8 year period. Yet even here, the data supplied cannot possibly do the trick. One set of data, supplied by Dr. Cryan and based on ERS figures, purports to support a 38% increase in the cost of maintaining a Grade A supply between 1998 and 2005, and it is that figure that the proponents use to support a 15 cent increase in the Class I price.

But the other farm cost of production data provided by proponents came from Northeast Farm Credit Associations (NFCA), and unlike the ERS data, is a summary of actual data from 539 actual dairy farm operations.

The total cost of producing milk submitted by NFCA show a far smaller increase in total costs of production between 1998 and 2005, with costs rising less than 5.3 percent from \$13.82 to \$14.55. This is nearly an order of magnitude lower than that reported by NMPF. Even using the data presented by NFCA limited to only a few cost categories known as labor, resources and utility, the increase from \$6.71 in 1998 to \$7.52 in 2005 is less than 12.1 percent, more than two-thirds less than the data presented by NMPF. This is a summary of real cost data from actual dairy farms analyzed between two years using the exact same methodology.

I do not see how proponents can expect USDA to take action significantly increasing Class I differentials when their own data is so self contradictory.

Furthermore, there is every reason to question the use of the ERS data upon which NMPF relies. As noted, NMPF uses USDA, ERS data to allege that non-feed costs of production have increased more than 38% over the 1998-2005 time period. However, the ERS website cited by NMPF notes that "Since cost-of-production data for any particular enterprise are

only collected about every 4-8 years, estimates for non-survey years use the actual survey year as a base and use price indices and other indicators to reflect year-over-year changes. This can cause discontinuities when new survey data replace these non-survey estimates. The magnitude of these discontinuities depend on how much technical and/or structural change occurred in the sector between the survey years, as well as changes in the sampling, questionnaire, and other data collection procedures." . For dairy, the 1998 data base survey year was 1993, and for the 2005 data the base cost data was 2000. Not only is the 1998 data not comparable to that from 2005, both of those years are based on 5 or 6 years of index updates and could bear little resemblance to actual costs of production in those years.

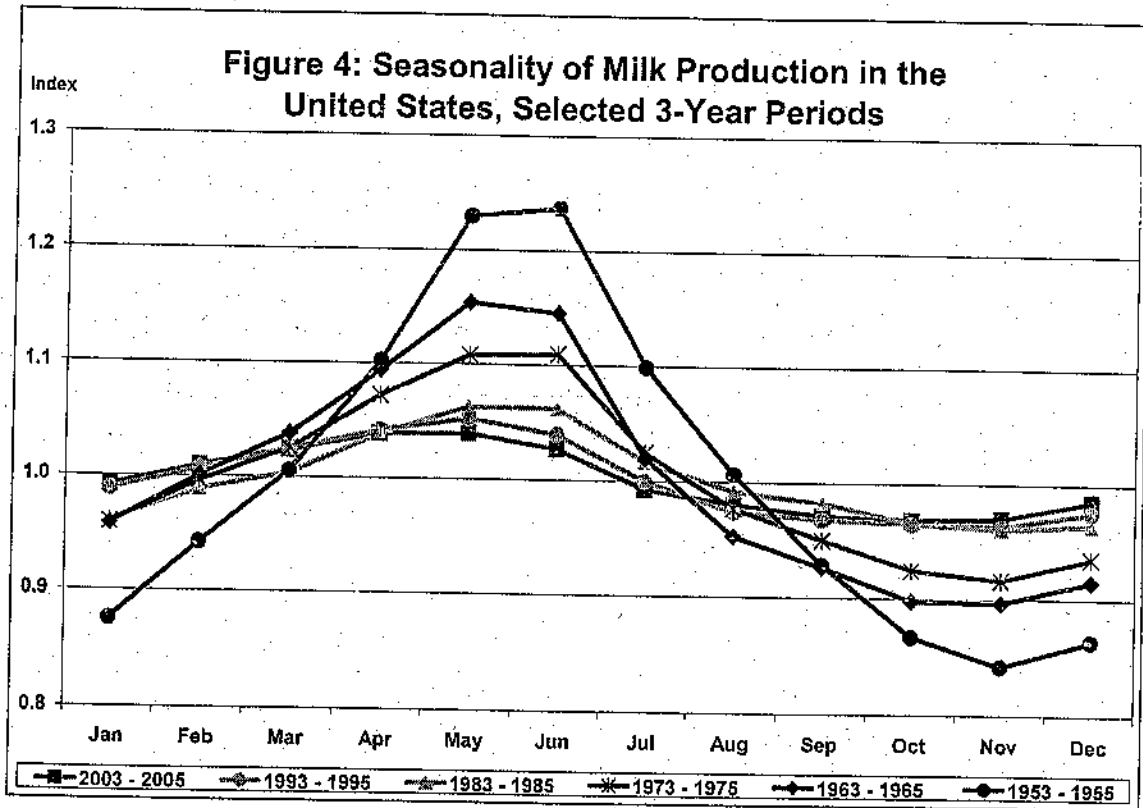
Even the updates for changes in output per cow and number of cows per farm as listed by ERS are not consistent with data on those changes reported by USDA, NASS for all of the U.S. For example, the ERS costs of producing milk data indicate that was based on a herd with 93 cows for 2000, but only 96 cows in 2005 (no such supporting data on herd size and output per cow were provided prior to 2000), an increase on only 3.2 percent. Yet the data reported by NASS shows the average U.S. herd size increased from 87 milk cows in 2000 to 115 milk cows in 2005, an increase

of 32 percent, an order of magnitude greater. And, of course, as herd sizes increases, costs per hundredweight generally decrease.

For output per cow, the story is similar. The ERS costs of production data is based on an output per cow of 19,974 in 2000 and increases to only 20,045 in 2005, an total increase of less than 0.4 percent for the entire five year period. On the other hand, NASS reports that the average milk output per cow in the U.S. increased from 18,197 in 2000 to 19,576 in 2005, an increase of 7.6 percent during those five years. Again, as production per cow increases, costs per hundredweight generally decrease.

**Marketing costs.** A second factor cited by proponents requiring an increase in the minimum Class I and II milk prices is marketing costs incurred in supplying the Class I market, including the costs of balancing supply and demand. Yet the proponents have provided no evidence regarding actual costs of balancing, instead relying on plant cost of manufacturing data. This approach ignores salient information regarding balancing, such as the fact that the seasonality of milk production has declined over time, including during the period since 1998, thus sharply reducing balancing needs (see figure 4).





Thus, the need to perform seasonal balancing has decreased, not increased, since 1998.

As with its discussion of Grade A versus Grade B milk costs, proponents look only at increases in secondary factors rather than presenting direct analysis of balancing costs then and now so a true comparison can be made.

In addition, one must question the logic of how this proposal will address the problem alleged by proponents. Nearly all these cost factors are post farm gate - seasonal and daily reserve balancing of milk supplies, shrinkage, administrative costs, and opportunity or "give-up" charges at

manufacturing milk plants that service the fluid Class I markets. How does requiring milk processors to pay dairy producers cover this cost? Unless there is some additional proposal that takes that money out of the dairy producers mailbox and requires that it go to cover the marketing costs outlined above, those costs still must be covered by others in the marketing channel. And just to repeat a statement from earlier in my testimony, USDA concluded in a January 2005 decision that the make allowances used in the Class IV price formula already account for balancing costs.

Proponents also make their case for increases in balancing costs using RBCS data relating to general plant manufacturing costs. But USDA determined that this data was not reliable as a source of manufacturing cost data in the recent make allowance decision:

"In addition, the RBCS survey costs do not conform to reasonable expectations of economic theory that predicts declining average costs where production volume increases directly with plant size." Fed Reg Vol 71 No 225 page 67484.

And later:

"Accordingly, the record does not support concluding that the cost of fuels as reported in the RBCS survey reasonably represents the costs of fuels experienced by manufacturing plants." Fed Reg Vol 71 No

225 page 67485.

And finally, the tentative final decision resulting from the make allowance hearings this year concluded that the make allowance increases should be far less than that used by proponents to justify a 13 cents per cwt increase in the Class I price due to increases in balancing costs.

Proponents also allege that average hauling costs are increasing in the marketplace. Data from a recent publication by the Minnesota Department of Agriculture refute that assertion, noting that average hauling rates paid by dairy producers in Minnesota declined fairly steadily between 1982 and 2003. I ask that this be marked as Exhibit [redacted].

"Historical data shows Minnesota producers overall pay a decreasing rate for milk hauling during the past two decades (Table 4). The hauling rate in May 2003 reached a record low of 17 cents per hundredweight." Milk Hauling Cost In Minnesota, prepared by Su Ye, Agricultural Marketing Services Division, Minnesota Department of Agriculture, September 2003 (<http://www.mda.state.mn.us/mktresearch/03milkhaulcost.pdf>).

While that same report noted that this may be due to subsidization of some of the costs of hauling by the buyer of farm milk, the proposal at issue here would not ensure that the entity bearing the cost receives the benefit of

the proposed increase in the Class I milk price. In addition, that same publication noted a significant and negative relationship between average volume shipped per farm and average hauling charges paid by producers. As structural change and the trend of rapidly increasing average herd size continue in the dairy industry, this relationship suggests hauling charges to dairy producers will continue to decline on average in the future, not increase.

Finally, as testified to by others, some marketing areas have specific provisions for covering increased costs associated with transportation to more distant processing plants. In these marketing areas, adoption of the proposals presented at this hearing would result in paying for the same thing twice.

**Over order premiums.** Finally, proponents also claim that increases in the average level of over order premiums in one market is sufficient evidence that the level of Class I prices should be raised nationally. Not only is this approach flawed in that relative changes in over order premiums vary considerably across marketing areas, but also because proponents ignore the fact that the result of the federal order reform process implemented in January 2000 increased the average level of Class I prices by more than the proponents are claiming is needed now.

The 1999 final decision included two provisions which directly impacted the Class I price level. The first change was to the minimum level of Class I differential, which USDA proposed to be \$1.20. However, subsequent action by Congress forced the dairy industry to adopt modified Option 1A, with a minimum Class I differential of \$1.60. In fact, the adoption of a minimum Class I differential was an increase from the \$1.20 in place prior to federal order reform in Minneapolis. Therefore, some of the increase in the difference between the fluid grade milk price series in Minnesota and Wisconsin and the Class III price reported by proponents was due to an increase of the minimum Class I differential (and, therefore, an increase in the Class I price) due to order reform itself. Like the perpetual Class I price increase machine proposed by proponents for evaluating changes in the cost differences between Grade A and Grade B milk, this also will lead to constant demands to increase the Class I price based on this flawed analysis.

If USDA adopts proponents proposal to increase the Class I price by 77 cents per cwt, the very next month the NASS fluid grade milk price series will reflect this increase, and proponents or others will come right back to USDA using the new, higher difference between that price and the Class III price as a reason for another increase. Talk about circularity! Even if

market conditions in some months lead to a narrowing of the difference between the fluid grade price series and the Class III price, opponents like IDFA or others would demand the same consideration of a decrease in the Class I price.

But, this was not the only source of direct impact on the Class I price level. The final rule also required the use of the higher of the Class III and IV price formulas as the Class I mover. Previously, the mover had been the Basic Formula Price, which is equivalent to the Class III price since 2000. For the six year period from implementation of order reform in January 2000 through December 2005, the Class I mover based on the higher of the Class III or IV price formula averaged 48 cents more than had the Class I mover still been based on the Class III price alone. So, there has been on average an increase in the Class I price equal to 9 cents more on average than proponents claim is necessary today to address increases in differences between the fluid grade and Class III price and the increase in the overorder premiums.

In addition, comparisons of over order premiums between 2004-2005 and most any other two year period has the problem that significant volumes of milk were depooled in certain months, especially in 2004. A close look at

the monthly data for premiums levels by month show that fluid plants were forced to pay higher premiums to get milk due to that depooling.

As a final point on overorder premiums, they can adjust to rapidly changing marketing conditions, both over time and across regions. Class I minimum prices do not have that same luxury, as it can take many months and even years from the time a petition is filed until a final decision is issued by USDA to amend federal orders.

Petitioners only looked at competitive factors in the states of Minnesota and Wisconsin and nearby cities. USDA, NASS publishes data on fluid grade milk prices for all states, and USDA, AMS reports monthly differences between the federal order Class I price and the announced cooperative Class I prices (used by proponents to present overorder premiums) for over 30 cities. In some markets, the over order premium never has reached even the 39 cents proponents claim is the *increase* since 1998.

One last point on overorder premiums, and perhaps the most important of all. The critical difference between over order premiums and the Class I minimum regulated price is that over order premiums actually moves milk to the Class I handler, while higher Class I minimum regulated prices do not. They do not because all dairy producers receive the blend

price, and thus have no incentive to provide milk to a fluid handler due to a higher Class I price. Give up charges, etc., in the form of over order premiums, are still the key.

**Class II.** USDA should reject the proponent's proposal to increase the Class II price due to the fact that USDA's impact analysis shows it would have just the opposite effect proponents are striving for - higher farm milk prices. Other witnesses will also address the incentive the proposed change would create for the substitution of Class IV products for fresh cream.

For all of these reasons, the proposals should not be adopted.