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TESTIMONY OF INTERNATIONAL DAIRY FOODS ASSOCIATION
FEBRUARY 2007 FEDERAL MILK ORDER HEARINGS
DOCKET NO. AO–14–A77, et al.; DA–07–02

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, the members of IDFA and its constituent organizations have a critical interest in these hearings. Most of the milk bought and handled by IDFA membersis purchased under the Federal milk marketing orders 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.

This hearing was called to consider whether any changes should be made in the Class III and Class IV milk pricing formulas. IDFA and its constituent groups submitted two of the proposals that were included in the Notice of Hearing, and my testimony will address both the reasons why those proposals should be adopted, and why other proposals should not.

To summarize IDFA's positions, we support the adoption of Proposals 1, 9 and 12; and oppose the adoption of Proposals 3, 7, 8, 14, 15, 16, 17, 18 and 20. We have no position on Proposal 13 and the portion of Proposal 6 that changes the butterfat shrink adjustment and yield factor from 1.20 to 1.211, but oppose the portion of Proposal 6 that would change the butterfat recovery factor from 90

to 94 percent. We support Proposal 2 insofar as it would call for annual surveys of the costs of manufacturing, but do not support that Proposal to the extent that it would call for the automatic updating of the make allowances by USDA without a hearing. IDFA believes that Proposal 10 goes in the right direction, but that IDFA's own Proposal 9 is superior to Proposal 10. IDFA believes that Proposal 11 goes in the right direction, but that IDFA's own Proposal 12 is superior to Proposal 11. We understand that Proposals 4 and 5 have been withdrawn, and therefore are not commenting on them.

The Fundamental Features of Product Price Formulas. Let me begin by pointing out some fundamentals of the current minimum price setting mechanisms, which we believe provide critical insights into the approach that USDA must utilize when addressing the proposals before us and resolving any disagreements or uncertainties as to the underlying factual data.

Since January 2000, Federal orders have utilized the price of finished products to determine the minimum milk prices that must be paid to farmers through a mechanism commonly referred to as a "product price formula." Oversimplifying slightly, a product price formula sets the minimum price that farmers must be paid for their milk (at least by proprietary handlers) as the price handlers receive for their finished products (cheddar cheese, dry whey, butter and nonfat dry milk) minus the costs handlers incur in turning farm milk into those finished products (commonly referred to as the "make allowance"). In performing this calculation, USDA must make assumptions as to how much of the finished products can be made from a given quantity of milk (the "yield factors").

In general terms, a make allowance is the difference between the wholesale sales value of a manufactured dairy product and the cost to purchase the raw milk necessary for that product's production. This make allowance is used for many economic purposes, e.g., to pay for the use of the capital necessary to build and maintain the plant, to cover the non-milk costs relating to obtaining raw milk, to pay for marketing the processed dairy product, to pay wages to employees of the manufacturing plant, to pay utility companies for the water, electricity and natural gas used to manufacture the dairy product, to buy ingredients other than raw milk, and to cover a wide variety of other expenses such as plant maintenance, equipment, and insurance.

A hypothetical, but realistic example may help explain the concept of make allowances in product price formulas. Assume the example where the wholesale price of cheese is $1.40 per pound and the total costs of manufacturing and marketing that cheese is 20 cents per pound of cheese. A manufacturing plant facing these assumed econornic factors would be able to pay up to $1.20 ($1.40 minus $0.20) for the raw milk needed to manufacture each pound of cheese.

What if this hypothetical plant is regulated under a federal order? If the make allowance specified in the regulated minimum price is 20 cents, this example plant can pay all the costs associated with manufacturing and marketing cheese after paying the regulated minimum milk price to the milk producers supplying the raw milk.

If, on the other hand, the make allowance specified in the regulations were 15 cents, the plant would be required to pay a minimum price of $1.25 ($1.40 minus $0.15) to milk producers supplying milk. In this scenario, the plant would still receive the wholesale cheese price of $1.40, but after being required to pay the minimum milk price of $1.25 would only have 15 cents left to cover the total costs of turning that milk into cheese. But with actual total costs of manufacturing and marketing cheese of 20 cents, the plant would be unable to pay for one or more factors of manufacturing and marketing. Obviously the plant could not continue to operate like this for any extended period of time.

It is easy to see through this simple but accurate example the critical need for a make allowance that covers the total costs of turning raw milk into a finished dairy product. Without an adequate level of make allowance, a manufacturing plant could not continue to operate, as it would have insufficient funds available to pay the vital costs necessary for operating the plant.

What is equally important to recognize is that the handler cannot escape from its conundrum by raising its finished product prices, either. We can see why this is so by returning to our example. Recall that the handler is selling cheese for $1.40, the make allowance is 15 cents, and the minimum price of milk is therefore $1.25. The handler is losing 5 cents for every pound of cheese it makes because its true costs of manufacturing is 20 cents, but it only has 15 cents left over after it pays for its milk.

So why can't the handler simply raise its sales price to $1.45? The problem lies in the federal order minimum price formula. As previously noted, the

minimum price is the price of the finished product minus the make allowance. In our example, before any finished product price increase, the minimum milk price was $1.40 minus 0.15 equals $1.25. After the finished product price increase, the minimum milk price is $1.45 minus 0.15 equals $1.30. Thus, all of the money derived from the increase in the finished product price has gone directly to the farmer, in the form of a'higher, legally-mandated minimum milk price. None of the money derived from the finished product price increase has gone to the handler. After paying the now higher minimum milk price, the handler still only has 15 cents left over—precisely the same amount as before it raised its finished product prices.

The same effect will result no matter how much (or, for that matter, how little) the handler attempts to raise its finished product prices. You can plug any price increase you want into the equation. The result is always the same, because the pricing formula works as a ratchet. All of the finished product price increase gets passed on to the farmer in the form of a higher minimum milk price. None of it is available to the handler to make up for the shortfall between the make allowance and the handler's true costs of manufacturing. Any steps it might take would be as futile as a dog chasing its own tail.

I would add to the foregoing the critical observation that exactly the same problems are created if USDA uses incorrect data or assumptions in determining the product price paid for the finished products, or the yields that a manufacturer is assumed to achieve in turning raw milk into a finished product.

If, for example, the formulas were to assume that the processor is receiving $1.40 for cheese when the price is really $1.35, the formula is condemning the processor to suffer a $0.05 loss on every pound of cheese it sells (even assuming USDA has accurately set the make allowance and yield factors). This is so because the processor must pay the product price minus the make allowance to the producer as a minimum price, and if the product price is $0.05 too high, the amount the processor it is allowed to keep will be $0.05 less than its cost of manufacture, even if the make allowance and yields are accurate. For example, the processor would be paying as a minimum milk price $1.40 minus 20 cents equals $1.20, but if it only received $1.35 for the cheese, the amount it would actually have in hand would be $1.35 minus $1.20 equals $0.15, which is $.05 less than what the processor needs to cover its costs of manufacture.

In reality, and as I will discuss later in greater detail, I believe that the current formulas contain precisely this kind of erroneous product price, because the current formula overstates the amount that processors receive in the marketplace for whey cream.

Similarly, if the formulas overestimate how much finished product is being obtained from a given quantity of raw milk, i.e., the yield factors, the formulas are dooming manufacturers to incurring losses, because the formulas will assume that processors are selling more finished product, and thus obtaining greater revenues in the marketplace, than is in fact the case. Several of the yield factor proposals under consideration at this hearing would, if adopted, have this

effect, and for that reason must be rejected, as I will explain in greater detail shortly.

The foregoing aspects of the use of product price formulas illustrate how much heavier USDA's responsibilities have been since 2000. Or, to put it more bluntly, these aspects reveal how much damage -- sometimes even catastrophic damage -- USDA can cause if it gets things wrong.

Before 2000, USDA utilized a system which based minimum prices on the competitive pay price paid by manufacturing plants in Minnesota and Wisconsin to producers of unregulated Grade B (manufacturing grade) milk to set regulated prices; this was known as the M-W price series. Thus, the free market for farm milk set the regulated price, and resulted in an implicit make allowance for each manufacturing plant, equal to the difference between the wholesale value received for the dairy product minus the value paid for the raw milk used to make that dairy product. This varied over time based on many economic factors such as the capacity utilization of the plant, variability in the cost of inputs other than raw milk like wage rates, energy costs and interest rates, and of course the competitive environment for raw milk. Market conditions automatically and continuously determined what the raw milk price should be, and how much of the finished product price a processor would retain. USDA did not have to make those determinations; the market did so. To a large extent, the system was on auto pilot.

Now, USDA must try to mimic these market forces through product price formulas -- and market forces cannot step in to fix the situation if USDA has

assumed finished product prices that are too high; established yield factors that are too high; or established make allowances that are too low. For the reasons I have already discussed, a processor in any of those scenarios will be required to pay a minimum milk price that leaves it an inadequate amount of money to cover its true costs of manufacture; and the processor cannot raise its prices in the marketplace to try to compensate, because that will only increase the minimum milk price the processor owes.

I believe that the recent vote in the Upper Midwest order, which I understand nearly resulted in the termination of that order, was a direct result of the considerations I have outlined. Cooperatives with manufacturing facilities in that order concluded that the product price formulas did not accurately reflect their true costs of manufacture, and thus doomed them to slow financial ruin.

The challenges I have outlined are only exacerbated by the exceedingly long time it has taken to update make allowances. The federal order changes resulting from Agrimark's September 2005 request for an "emergency" hearing were not implemented until February 2007, seventeen months later (and were themselves insufficient for the reasons IDFA has pointed out in its comments on the interim decision). The sharply rising costs experienced during that intervening time could not be addressed at all, given the combination of the inherent inflexibilities of finished product price formulas and the inadequate make allowances that had been adopted in those formulas. These hearings provide the opportunity to fix those defects.

I will make two critical additional observations before turning to the specific proposals before us. First, there should be no concern that applying the principles I have espoused will result in make allowances that are too high, yield factors that are too low, or product prices that are too low, such that producers will be "cheated" out of a rightful price for their milk.

We are only dealing here with minimum milk prices. Cooperative associations will pass on to their milk producer members all of the wholesale sales value of dairy products in excess of that needed to cover the total costs of manufacturing. Since cooperative associations are significant players in the manufacturing of dairy products, they are a considerable force to be reckoned with in the marketplace. In order to remain competitive in the marketplace for raw milk, a proprietary plant would have to pay an amount at least equal to the cooperative association in the above example, as an over-order premium. In short, market forces will result in over order premiums that will adjust the amount being paid to producers if make allowances are set at a level higher than the actual cost of production, yield factors are set at a level below actual yields, or product prices are assumed to be lower than they really are.

There is nothing revolutionary about relying on the market for these purposes -- after all, that is exactly what federal orders did for the first '67 years of their existence.

My second overall observation goes to the completely mistaken notion that the product pricing system provides a fixed margin for processors but no safety provision for farmers, or that the system somehow forces farmers to bear

the cost of cost increases at the manufacturing level. Processors whose costs are above the make allowances must either reduce their costs or suffer losses; and processors whose costs are below the make allowances will face competitive pressures for milk supplies that will result in over order premiums.

As for producers, they must be subject to price signals that will cause them to produce more milk when rising market demand for finished dairy products dictates the need for more milk, and to produce less milk when falling product demand so dictates. No purpose would be served by regulated milk prices that induce increased production without any market outlet.

Balancing this economic necessity is the fact that, unlike regulated processors, producers are not subject to regulations that fix the maximum margin between their output price and input costs. Indeed, one can only imagine the screams of protest that would have issued in 2004 and 2005, when we encountered the highest two year period of farm milk prices on record, if dairy producers had been required by regulation to pass on those higher milk prices to their suppliers of grain or other inputs.

Proposal No. 1

IDFA supports Proposal 1, which would update the make allowances used in the product price formulas used in all Federal order minimum class prices to reflect the most recently published costs of processing data from the California Department of Food and Agriculture (CDFA). On November 29,2006, CDFA published summary data from their latest study of processing costs. USDA noted

that costs of processing data from both CDFA and CPDMP were representative of actual industry costs of processing and were comparable in methodology, and therefore both should be used in determining make allowances. This new data from CDFA has already been admitted as Exhibit 10.

As USDA repeatedly noted in the recently implemented Tentative Decision resulting from the January and September make allowance hearings (Tentative Decision), the CDFA data on the costs of processing represents an audited survey of manufacturing plants in that state. The CDFA survey data results have been endorsed and utilized by USDA since 2001 to set make allowances. There is therefore no reason not to incorporate the latest CDFA data in setting make allowances.

In the Tentative Decision, USDA only used the CPDMP data in setting the whey make allowance. IDFA submits that this was in error.

USDA stated that:

"In the CDFA survey, dry whey drying costs may be unreasonably high because California has only three dry whey processing plants where high cost plants appear to skew the costs dramatically."
71 Fed. Reg. Page 67485.

No data was presented at the hearing that could allow USDA to reach such a conclusion, given that individual plant data was not revealed and therefore no determination can be made about the distribution of costs of processing among the three plants in the CDFA survey.

In fact, the data that is available points to the opposite conclusion than that reached by USDA. USDA NASS reported that there were only 5 plants in California producing dry whey in 2004, and the three plants (60% of all the dry

whey plants in California) in the CDFA cost survey represented nearly 79% of the USDA NASS reported dry whey production in that state that year. The two plants not in the survey have far less volume processed, on average, than the three plants that were included in the CDFA survey. Give the record evidence as to the positive effect of economies of scale on processing costs per hundredweight with respect to all dairy products, these two excluded plants in all likelihood had materially higher costs per hundredweight than the three surveyed plants. The CDFA data, if anything, under-reports the average costs of processing dry whey for all five plants in that state.

In addition, a comparison of the average volume processed per dry whey plant among NASS, CPDMP, and CDFA reveals that it is the CPDMP data that is less comparable to the national average plant size than the CDFA data, not the other way around. The average dry whey plant in the CPDMP survey processed over 77% more volume than the NASS national average, while the average dry whey plant in the CDFA survey only processed 16% more. Therefore, the CDFA survey is more representative of the U.S. average than the CPDMP survey with respect to the costs of processing dry whey.

USDA should therefore include both the CDFA and CPDMP survey weighted average data in determining the dry whey make allowance. Table 1 to this statement shows how USDA only used the CPDMP data to determine the dry whey make allowance in the Tentative Decision, and also shows how the latest CDFA data should be incorporated in determining the dry whey make

allowance using the same methodology as that used by USDA to combine the CDFA and CPDMP data for the other three products.

The current incorporation of the CPDMP on cheese production costs also is in need of an important adjustment. As USDA noted,

"The CPDMP study sample of cheese plants is not a random sample. It is a stratified random sample where randomness only applies to strata (size related groupings) of the surveyed plants."

And later,

"This sample design was intentionally biased to over-represent large, lower cost plants. The record shows that large plant costs otherwise would have been seriously underrepresented if the survey had relied on a truly random selection of cheese plants." 71 Fed. Reg. Page 67485.

Given these observations, which are entirely accurate, USDA in its Tentative Decision clearly should have corrected for this intentional bias in the CPDMP survey before applying the survey results to set make allowances for all Class III plants in the federal order system. By using a stratified sample, Dr. Stephenson over-sampled larger plants. Given that larger plants are, other things equal, more efficient, this meant that Dr. Stephenson was over-sampling plants with relatively low costs of processing. If one does not adjust for that fact, the survey results will significantly understate the costs of processing among cheese plants as a whole. Thus, if one does not adjust for that fact, one will set a make allowance that is too low.

The need to make this correction is particularly great given that the stratified sampling technique employed was chosen for the specific purpose of providing information that could (if properly adjusted) be used to set make allowances. USDA itself sponsored and partially covered the expenses

necessary to conduct the CPDMP survey of the costs of processing, and was fully aware of the sampling technique to be used.

Having used a stratified sampling technique, one obviously must adjust for that stratification when using the survey results in determining average costs of processing by all cheese plants.

USDA in its tentative decision noted that,

"Even if the methodology used to calculate the estimated make allowance of $0.2028 per pound of cheese was statistically acceptable, the Department would not use it as the new make allowance for cheese. The use of different methodologies to establish make allowances for different products likely would result in unintended consequences that could distort the competitive situation between cheese plants and butter-NFDM plants." 71 Fed. Reg. Page 67486

The comment misperceives the situation. The "use of different methodologies" did not relate to CPDMP's calculation of a population weighted average for cheese but not for the other products, but rather referred to the use of a sampling technique for cheese that was different than the sampling methodology employed for the other products. The cheese costs of processing survey was developed using a **stratified** random sample, while the surveys for the other products used a **non-stratified** random sample. There was thus an inherent need to correct for stratification with respect to the cheese survey, and inherently no need to do so for the other surveys.

Having adopted a stratified sample technique for cheese (a methodology different that that employed for the other three products), one cannot fail to take the necessary next step and correct for the stratification when applying the results to cheese plants as a whole as a necessary result of having decided to use a different sampling methodology in the first place. There was no *a priori*

statistical reason to make such a correction to the sample results for dry whey, butter and nonfat dry milk because a stratified sample had not been used.

The fact that, as USDA notes, *"CPDMP did not have similarpopulation data available to do comparable regression analyses for butter, NFDM and dry whey,"* **thus becomes irrelevant.**

USDA observes that:

"It is possible that if the regression methodology could be used for butter, NFDM and dry whey that estimated average make allowances for those products also would be higher than the weighted average costs from the plant samples." *71* Fed. Reg. Page 67486-7.

This might be true, but we do not know whether this is true, and do not need to know because a stratified sample was not used for these other products. The reasons why such a stratified sample was used for cheese, and properly so, were recognized by USDA and are discussed above. Cheese plants cannot be saddled with a make allowance that is too low merely due to speculation as to what the make allowance might be for other products had alternative survey methodologies been utilized for them.

Therefore, USDA must correct for the intentional sample bias in the CPDMP cheese costs of processing survey and use the corrected population weighed average estimate for this product's cost. It is, therefore the "Weighted Average Processing Costs for Cheddar Cheese" plants outside of California that must be used. The top portion of Table 1 shows the method used by USDA in the Tentative Decision to determine the make allowances to be used from combining the CPDMP and CDFA data. IDFA believes that USDA should adopt the methodology shown in the bottom portion of that table. Specifically, the

population weighted average processing costs for cheddar cheese as testified to by Dr. Stephenson should replace the sample weighted average cost used by USDA in the Tentative Decision by replacing the $0.1638 sample average with the $0.2028 population average. In addition, it shows the use of CDFA dry whey data in the determination of the dry whey make allowance.

When the most recently published CDFA data from Exhibit 10 is combined with the NASS 2005 Dairy Production volumes for the California and the rest of the country (the most recent annual data available - the next data to be published in the April 2007 edition of the Dairy Products Annual Summary), the result of these changes are that USDA should set make allowances at least as high as the following: for cheese $0.2017; for butter $0.1214; for NFDM $0.1630; and for Dry Whey $0.2069. These are the make allowances that USDA should adopt.

Proposal 2.

IDFA supports the concept of having USDA conduct an annual manufacturing cost survey of cheese, dry whey, butter, and nonfat dry milk plants (located outside of California) as contained in Proposal 2.

As stated in my comments on using the most recent data available and in others' testimony at this hearing, make allowances determine the portion of a finished product's value that remains with the processor, or better stated, is not passed back to the farmer or cooperative first selling that milk. Manufacturing costs change over time for a variety of reasons, both up and down. Maintaining a make allowance that properly rewards farmers and processors, both

proprietary and cooperative, while not disrupting the market for end products is one way to ensure an orderly market.

Monitoring the costs associated with producing these products through a regular, annual or bi-annual survey of plant costs will provide data to the industry that will serve two very important functions. First, these results will illuminate trends in plant costs where current regulations are becoming obsolete. Second, this will provide ready input to future hearings on how these make allowances should be adjusted. This will facilitate a much more rapid updating of make allowances than has been achieved in the last few years, during which we have, until this month, been living with make allowances based on costs surveys conducted in the late 1990s.

However, IDFA opposes the concept of *automatic* annual updates to the manufacturing make allowances based on such a survey. We believe that the hearing process provides the opportunity for the industry to provide important input as to the method by which the updated data should be utilized given the complexities created by the use of stratified samples and the like.

Proposal 3.

Proposal 3 would reduce the current make allowances, by eliminating the use of CDFA cost of manufacturing data. IDFA opposes Proposal 3 for the reasons described in the section above in support of Proposal 1. In addition, since USDA first adopted product price formulas for all class prices as part of the Federal order reform process, it has correctly recognized that costs of processing

from the CDFA survey should be included when determining the appropriate level of make allowances. The CDFA survey provides audited data, collected by trained individuals, pursuant to longstanding and well regarded practices. It would be a big mistake for USDA to turn its back on the CDFA data.

Proposals 6, 7 and 8.

IDFA opposes Proposals 6, 7 and 8, all of which propose to adopt changes in the yield factors used in the product price formulas. As noted earlier in my testimony, it is absolutely critical that USDA avoid adopting yield factors that are not representative of actual industry data. In addition, USDA must consider the entirety of the processing sector regulated by Federal orders, not merely the most efficient processing facilities.

In April 2003, USDA implemented the final rule resulting from the May 2000 national hearing, the last to consider proposals to change the yield factors. USDA correctly concluded that various factors should be included when setting yield factors, among them including an allowance for farm-to-plant shrink, allowances for secondary products like buttermilk which have lower value in the marketplace than nonfat dry milk, and using assumptions regarding buttetfat retention in cheddar cheese which allow for the range of retentions achieved by plants with different processing technology. If anything, USDA should modify the current yield factors to account for within plant loss of components that reduce the capture rate of whey cream and the reality of off-grade products that sell at a discount to the market prices as reflected in the NASS survey.

The Yield Factor Cannot Be Set at a Level That Ignores Shrinkage. Component tests on producer milk are conducted at the farm bulk tank, but processors can only manufacture products from the components that actually reach the plant. Along the way, both milk and components are lost as farm milk is transferred from the farm bulk tank to the transport tanker, and again in the ,transfer from the tanker to the plant at the receiving area. Others will present actual data on the milk volume and component loss during the process of moving milk from the farm bulk tank to the plant, but the data presented thus far suggests that the current yield factors are, if anything, on the high side because they reflect the low side of the true amount of farm to plant loss.

In addition, shrinkage results from the movement of milk and products within a manufacturing plant. Others will also testify about this loss, not only due to transferring milk in pipelines and other processing equipment, but also as reflected in the small percentage of every plant's output which is off-grade and must be sold at a discount to the NASS survey prices in the marketplace.

These sources of shrinkage are not accounted for in the make allowance or anywhere else in the product pricing formula. The shrinkage should be accounted for in the yield factor. USDA should reject any proposal calling for yield factors that ignore this significant factor, which is a market reality in the dairy industry.

Formulas cannot ignore the reality that secondary products like whey cream and buttermilk have lower value in the marketplace than sweet cream and nonfat dry milk. Secondary products, like the butterfat in whey

cream resulting from the manufacture of cheddar cheese and the buttermilk resulting from the manufacture of butter, must be considered when setting yield factors for the product price formulas. Adopting yield factors which assume these secondary products have the same value as Grade AA butter in the case of whey cream, and the same value as nonfat dry milk in the case of dry buttermilk, ignores the market reality. Other witnesses will be testifying regarding the market value differences between these products.

Proposal **9**

IDFA's proposal number 9 is intended to rectify the error in the current Class III formula that results in the valuation of all of the fat that is used in cheddar production, but is not captured in the cheddar cheese, as grade AA butter. The specific factor in the current formula that causes this error is the 0.9 factor in the protein formula. This factor is in the part of the protein formula that adjusts for the difference between the fat value in cheese relative to the fat value in butter (the price paid for the Class III fat component). The practical effect of this factor is that 10% of the fat is priced at the grade AA butter value.
This is an erroneous assumption in two ways: (1) not all fat not captured in cheddar cheese can be recovered and (2) the fat that is recovered from the whey stream commands a lower value in the marketplace than Grade AA butter. IDFA member testimony to be given later in the hearing will speak to the specific recoveries and valuation of whey cream.

The protein formula should include a yield factor to account for the difference between the whey cream value and the grade AA butter value that is used to price Class III fat and to account for fat losses . This should be done with a flat adjustment, similar to the AgriMark methodology in Proposal 10, but the adjustment should be reflective of the difference in value between whey cream and the grade AA butter.

Proposal 10.

IDFA supports the concept embodied in Agrimark's proposal 10 but, as noted above, believes that the adjustment must go beyond the difference in value between grade AA and grade B butter values.

Proposal 11.

IDFA also believes that Proposal 11, which calls for the reduction of the the 3-cent adjustment to the cheddar cheese barrel price to 1.5 cents, does not go far enough. Further elaboration is contained in our support of Proposal 12.

Proposal 12.

The 3-cent adjustment to the NASS barrel price is supposed to represent the difference in the costs of processing cheddar cheese in 500-lb barrels versus 40-lb blocks. Others will also testify and present actual plant data regarding the near zero actual difference between the costs of processing cheddar cheese in

barrels versus 40-lb blocks. Thus, the factual predicate for this adjustment will be shown to be mistaken.

In addition, the Cornell cheddar cheese costs of processing data used by USDA in the Tentative Decision to determine make allowances included both block and barrel plant data; therefore any difference in the costs of manufacture for blocks versus barrels is already represented in the make allowances used in the Federal order product price formula for cheddar cheese. Continuation of the 3-cent adjustment to the barrel price would result in double counting this factor.

Proposal 14.

IDFA opposes the adoption of Proposal 14, which would use a combination of the NASS and CME wholesale product price data in the product price formulas. Proposal 14 would add needless complexities and represents overkill in light of the problem it tries to address.

It is our understanding that an issue the proponents sought to address with this proposal was the lag from market activity to reporting by NASS. In the worst case, a product sale on Monday morning is included in the report filed the following week to be sent to NASS, where it is reviewed, tabulated, and reported the following Friday. We are sympathetic to the argument that this lag, especially in times of fast moving or very volatile prices, can create significant divergence between NASS reported market prices, hence the cost (or expected cost) of the milk input, and the actual market price for the product on a given day.

Shortening the delay between sale of a product and the corresponding NASS report would greatly reduce this divergence and its consequences.

We believe options are available to USDA-NASS to reduce this lag. For one, in this age of continuous and instantaneous communication, the NASS survey could be made electronic in reporting, review, auditing, and tabulation. In this way, the price and volume reports could be available on Monday morning, eliminating 4 days from the lag. Adoption of such measures is more consistent with past workings of the FMMO system since Order reform, and much simpler than the proposal 14.

Proposal 15.

IDFA opposes adoption of Proposal 15, which would substitute CME prices for NASS prices for all products except dry whey. The product price formulas used to determine minimum milk prices under the final rule are based on the wholesale selling prices of butter, cheddar cheese, non-fat dry milk and dry whey. As a primary building block of federal order minimum milk prices, these wholesale prices determine what handlers pay and producers receive for all milk regulated under the federal order program. Therefore it is imperative that the wholesale selling prices used to determine minimum federal order producer prices represent the wholesale value of the underlying product in the marketplace as accurately and completely as possible. Accurately representing the average wholesale price of these products in the marketplace can only be accomplished by including the largest possible sampling of wholesale prices.

For that reason, the product prices used to determine federal order minimum prices must represent actual market sales transactions. In addition, the product price data should represent transactions from all areas of the country, and not be limited geographically to any one sales region or adjusted to prices in any one region. Finally, such price data should include the largest volume of manufactured dairy products as possible.

Currently, only the dairy product prices survey conducted weekly by the National Agricultural Statistics Service of USDA meets these criteria. Proposal 15 would replace the NASS dairy products prices survey with data from the Chicago Mercantile Exchange (CME) spot markets. However, USDA in the Federal order reform final rule discussed the many reasons why the CME is not a suitable data source for any of the four products at issue. First, noting that the CME weekly cash butter contract had been used in setting the butterfat differential, the final rule states "This price series has been criticized due to the 'thinness of trading." With respect to cheese, USDA stated in the final rule "Criticism of the cheese exchange trading, including inaccurate representation of cheese prices and accusations of market manipulation, reached the point that the National Cheese Exchange (NCE) discontinued trading, and cash trading of cheese moved to the CME. The CME also has received some criticism for thinness of trading." While there exists a cash contract for nonfat dry milk at the CME, USDA noted in the final rule that, "There is very limited exchange trading of nonfat dry milk." Finally, there is no cash exchange market for dry whey.

All of the available evidence supports the correctness, both then and now, of USDA's decision in the Federal order reform final rule not to utilize CME data. To switch from the NASS data to the CME data would be to switch from a very broad, to an extremely thin, representation of actual cheese transactions. The same is true for butter and NFDM. For the period from January 2000 to December 2005 the NASS survey volumes represented 15.4 percent of all U.S. butter production, while CME trading volumes consisted of only 4.6 percent. Looking at NFDM over that same time frame, the NASS survey volumes represented 78.1 percent of all U.S. production, while CME trading volumes consisted of only 0.02 percent.

This thinness carries two consequences. First, it raises the very real prospect that the reported prices are not, in fact, representative of finished product transaction prices. But the prices used to set minimum milk prices must be accurate if the entire pricing system is to function properly. Second, these markets are sufficiently thin so as to encourage purchasing for the purpose of causing minimum milk prices to rise, if they formed the basis of minimum milk prices.

In addition to their thinness, the CME market is not national in scope. In the final rule, USDA noted that "the scope of the surveys that have been undertaken by NASS, and their geographic representation, appears to be comprehensive." But because the CME spot prices represent transaction prices adjusted to the Chicago market only, the CME spot prices do not satisfactorily capture the national scope of manufactured dairy product markets. Mr. McCully

will provide additional testimony regarding how the CME suffers from this shortcoming.

For the reasons I have just explained, the federal orders' reliance upon the NASS Survey should be retained. In fact, many of the reasons cited for changing to the CME could be addressed, at least in part, by changes in the NASS survey process. First, USDA should make reporting mandatory for all manufacturers of all products eligible to be reported in the NASS Dairy Products Prices survey. This would even further improve the completeness of this data in representing all eligible sales transactions. Second, USDA should implement a method to verify that data submitted on the survey is accurate. This could be as simple as requiring manufacturers submitting data to include the names and contact information of their three largest volume customers each week, which USDA in turn could use to conduct spot checks by making certain that the data reported by manufacturers was consistent with what customers reported paying. Third, USDA could require electronic reporting of the NASS Dairy Products Prices survey data, and report weekly data in a more timely fashion. For example, USDA could require the data for the prior week ending to be reported by COB Monday, and issue the Weekly Dairy Products Prices report on Tuesday.

Proponents of Proposal 15 also claim that the circularity associated with the use of NASS survey prices would be eliminated if USDA instead used the CME spot market prices. This claim appears to be based on the concept that industry participants commonly use the CME as a reference price, and actual sales prices for wholesale dairy product transactions occur at a set premium or

discount to the CME price. Proponents claim that by adopting the CME instead of the NASS survey prices, market participants can merely adjust this discount or premium to account for any higher costs of processing.

This argument ignores marketplace realities. It is very difficult for sellers of homogeneous non-differentiated commodities such as commodity cheddar to extract a premium from the marketplace. The buyer's alternative is to purchase product from the CME where they will not have to pay the premium or to procure from a competitor that is not similarly increasing prices.

Proposal 16.

We oppose Proposal 16 because of both its increased complexity and the distortions that will result from assigning the value of a product (whey) whose yield is dependent upon a milk component that is not highly variable (other solids), to a component that is highly variable (protein) across breeds.
The current set of regulations represents an intuitive understanding of the components of dairy products. Products with protein, fat, other solids, or some combination, are priced with those components in mind. In the case of Class III milk, this means the protein and fat that remain in the cheese are priced based upon the value of cheese. The other non-fat solids that remain can be dried and sold as dry whey, and their value in the current price formulas reflects this.

As can be seen in the Department's Preliminary Economic Analysis, the assignment of the value of whey to the protein component will increase the cost of high protein milk while reducing the cost of low protein milk. Since the other

solids components of milk do not move parallel to the protein content and are, in fact, relatively constant across breeds, these cost shifts are inconsistent with the whey yield that would be expected from high and low protein milk.

Proposal 17.

IDFA opposes adoption of Proposal 17, which would require automatic, monthly updates to the make allowances based on changes in price indices representing costs of electricity and other energy inputs.

Monthly adjustments complicate the process of risk management. By introducing another factor in the final benchmark price, regardless of how well documented and known, there is a greater chance that benchmark price will differ from an actual price to some market participant. In ,other words, there will be an increase in the basis risk for that participant. This addition of risk into the markets for dairy products will retard the acceptance and use of risk management tools for dairy products at a time when risk management is becoming a commonplace part of producer, processor, and end-user practices.

Proposal 18.

IDFA opposes adoption of Proposal 18, which attempts in some way to use a simulated competitive pay price series in determining Federal order minimum class prices for milk.

The proponents of this proposal have not yet appeared at this hearing and IDFA may need to return to the present further testimony following such

appearance. However, we do know that USDA abandoned the competitive pay price series know as the M-W price series with the implementation of Federal order reform amendments in January 2000. That price series had been based on Grade B milk pay prices, which had no minimum regulated prices requirements. However, over time both the volume of Grade B milk production and the decline in the number of plants purchasing Grade B milk caused USDA to conclude that it was no longer competitive in any way.

In'addition, during the Federal order reform process, USDA considered a competitive pay price for Grade A milk, but concluded doing so would not lead to a representative, competitive pay price for milk. As USDA noted in the April 1999 Final Decision on Federal order reform:

"Identification of a competitive pay price in today's dairy industry, where 70 percent of the milk is currently covered under Federal milk marketing orders, appears to be an unsurmountable challenge. After accounting for state regulations, only about two percent of Grade A milk is unregulated, and it is unlikely that even this small amount of milk is not affected by regulated prices. Only about five percent of the total milk marketed in the U.S. is Grade B or unregulated, and 42 percent of that milk is located in Minnesota and Wisconsin. The remainder is scattered among 23 states in amounts too small and delivered to too few processing plants to generate a competitive pay price. In areas where alternative markets exist, the price for unregulated milk likely is not below the price paid for regulated milk, since producers would prefer to sell their milk to regulated handlers to receive the higher regulated price. Thus, unregulated handlers are compelled to meet the regulated price in order to attract sufficient supplies of milk. The circular result is that the regulated price ultimately becomes the competitive price. This process does not lead to a representative competitive pay price for milk." 64 Fed. Reg. 16092.

Little has changed since the time of that decision, as today very little milk is not under either Federal order or state milk price regulation in the U.S.

Proposal 20.

IDFA opposes adoption of Proposal 20, but because the proponents have not yet appeared at this hearing, I will present further testimony on this proposal after they have appeared.

A comment on the use of farm costs of production in determining the Federal order minimum milk prices. In addition to this testimony on specific proposals, I note that several witnesses have indicated that USDA should consider farm costs of producing milk when setting Federal order minimum class prices for manufactured dairy products. While there are no proposals in the hearing notice directly addressing the use of such data by USDA, I offer the following comments.

As noted by USDA in its October 21,2001 recommended decision on Class III and IV product price formulas,

"The record of this proceeding contains no new dairy farmer cost of production data that could be used to reflect both the supply and demand sides of the market for dairy products. There is no evidence in the record that either USDA's Economic Research Service or the CDFA costs of production have ever been used to price milk.

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If conditions increase supply costs, the quantity of milk produced would be reduced due to lower profit margins. As the milk supply declines, plants buying manufacturing milk would pay a higher price to maintain an adequate supply of milk to meet their needs. As the resulting farm profit margins increase, so should the supply of milk. Likewise, the reverse would occur if economic conditions reduce supply costs. The price of feed is not directly included in the determination of the price for milk, but rather is one economic condition which may cause a situation in which the price of milk may increase or decrease. A change in feed prices may not necessarily result in a change in milk prices. For instance, if the price of feed increases but the demand for cheese declines, the milk price may not increase since milk plants would need less milk and therefore would not bid the price up in response to lower milk supplies. Also, other economic conditions could more than offset a change in feed prices and, thus, not necessitate a change in milk prices. The pricing system continued in this decision will continue to account for changes in feed costs, feed supplies and

other economic conditions, as explained above. The product price formulas adopted in this rule should reflect accurately the market values of the products made from producer milk used in manufacturing. As supply costs increase with a resulting decline in production, commodity prices would increase as a result of manufacturers attempting to secure enough milk to meet their needs. Such increases in commodity prices would mean higher prices for milk. The opposite would be true if supply costs were declining. Additionally, since Federal order prices are minimum prices, handlers may increase their pay prices in response to changing supply/demand conditions even when Federal order prices do not increase." 66 Fed. Reg. 54070.

This analysis of this issue by USDA is as correct today as it was then.

I note that proponents have introduced into evidence Exhibit 19, which provides certain dairy farm costs of production data from a USDA website. However, the USDA, ERS website cited specifically 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 depends 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."

With respect to Exhibit 19, all of the data presented, which purports to cover the years through 2006, was based on a survey conducted in the year 2000. Thus, the more recent 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.

In short, this data is very suspect, even assuming it would if accurate provide useful information for decision making.

Table 1

Tentative Decision	Butter	Nonfat Powder	Cheese	Dry Whey
Total 2005 US NASS Volumes	1,347,227	1,186,104	3,812,950	963,716
CDFA weighted average costs	0.1368	0.1730	0.1769	NA
CA NASS volumes	407,872	506,452	854,704	119,215
CA share of NASS	0.3027	0.43	0.22	0.12
CPDMP sample weighted average costs	0.1108	0.1423	0.1688	0.1941
Non-CA NASS volumes	939,355	679,652	2,958,246	844,501
Non-CA share of NASS	0.6973	0.57	0.78	0.88
CDFA and CPDMP weighted by NASS	0.1187	0.1555	0.1667	0.1941
Add marketing costs	0.0015	0.0015	0.0015	0.0015
Tentative decision make allowances	0.1202	0.1570	0.1682	0.1956

IDFA Proposed Make Allowances Using New CDFA Data	Butter	Nonfat Powder	Cheese	Dry Whey
Total 2005 US NASS Volumes	1,347,227	1,186,104	3,812,950	963,716
CDFA weighted average costs	0.1408	0.1872	0.1914	0.2851
CA NASS volumes	407,872	506,452	854,704	119,215
CA share of NASS	0.3027	0.4270	0.2242	0.1237
CPDMP population weighted average costs	0.1108	0.1423	0.2028	0.1941
Non-CA NASS volumes	939,355	679,652	2,958,246	844,501
Non-CA share of NASS	0.6973	0.5730	0.7758	0.8763
CDFA and CPDMP weighted by NASS	0.1199	0.1615	0.2002	0.2054
Add marketing costs	0.0015	0.0015	0.0015	0.0016
IDFA comment make allowances	0.1214	0.1630	0.2017	0.2069

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