

A Dairy Policy Action Coalition White Paper
"Working Draft"



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Cornerstones for Change

A preliminary report about U.S. dairy policy and the global realities of the 21st century

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Introduction

As we begin 2011, the dairy industry is still in a perilous state, financially. Dairy farmers have been pushed to the brink, and their livelihoods determine the financial well-being of their respective communities and statewide economies.

While the 2009 dairy crisis was rooted in world economic collapse, the severity and duration (into 2010) of losses in net farm income and equity on U.S. dairy farms is a direct result of federal dairy policies that fail both producers and consumers.

In short, the milk pricing system is broken. The continual process of patching and re-patching is not a satisfactory solution. The dairy industry needs a milk pricing system that reflects the global realities of the 21st Century.

Further complicating this picture is the new price levels for corn, soybean meal and other dairy feeds in recent years, despite record and near-record crop harvests. These new levels of high feed costs create difficult margins for both dairy and livestock producers. Continuation of ethanol subsidies are a contributing factor.

As a result, industry leaders have put more emphasis on “margin” protection and risk management, with less emphasis on solutions for the rapid and dramatic erosion of the farmer’s share of the consumer’s dairy dollar.

Yet, dairy producers have found that the lack of a functioning market, lack of timely price information, lack of market transparency, and a poor price discovery process make it difficult to manage risk in the way that other farm sectors are able.

This is why the Dairy Policy Action Coalition (DPAC) formed as a coalition of grassroots dairy farmers in November of 2009.

Sprouting initially in Pennsylvania and Ohio, farmers across the Northeast, Southeast and Central U.S. have quickly joined on with DPAC’s mission to actively participate, with a unified voice, on policies and issues affecting milk pricing.

Erosion of dairy farmer's share of consumer's retail dollar

A key area that must be addressed in any future federal dairy policy is the erosion of the farmer's share of the consumer's dairy dollar from 42% a few years ago down to 27% in 2009 and 2010, according to information presented by experts at the U.S. Department of Justice / USDA joint workshop on dairy market concentration, competition, and transparency in Madison, Wisconsin on June 25, 2010.

During the DOJ / USDA workshop, University of Connecticut agriculture marketing economist Ronald Cotterill, with the Food Marketing Policy Center, testified about **consolidation of the dairy marketing channel**:

"It's always amazed me how in the dairy marketing channel, the dairy farmer is probably the most efficient member of that channel, having tremendous efficiency gains over the last 30 or 40 years, absolutely amazing efficiency gains, but has the dairy farmer been able to capture any of that in terms of any kind of stable return? The answer is 'no.' It's clear we need a higher price via a larger share of the consumer's dollar. There's no doubt about that. The question is just how to do it. We also need a more stable price. There's no question about that as well. I think that we need a competitive market channel for efficiency in that."

Cotterill also noted that the way fluid milk is priced at retail has changed dramatically. Twenty years ago, milk was often a "loss leader," something that was sold low to bring people into the store. Now, milk is a "cash cow."

"Milk is the largest product in the American supermarket by sales volume in dollars, that is," Cotterill reported. "It is also the most profitable in many supermarkets. They have margins of

40% now, 45% is also common, whereas 20 years ago, the margins were 20%... The margin has expanded in those areas more than the costs have justified it. It's fundamentally a shift in the way they price milk."

Other farm sectors have also seen erosion of their share of the consumer's retail dollar, over time, but not as drastically as in the dairy sector.

Today's widening farm-to-retail price spread shows the "sticky" retail pattern, where retail prices rise more quickly when the farm-gate milk price rises, but as the farm-gate milk price falls, retail dairy product prices are slower to adjust, and thus, over time, the retail dairy product prices retain part of each prior milk price advance.

Furthermore, in 2007-08, the food industry reduced their package and portion sizes on many dairy food items to minimize the need for obvious price changes to consumers. Many of these default demand reductions are still in effect today.

Both examples, above, demonstrate ways in which value in the marketplace is not being passed back to the dairy farm sector. And yet, current federal dairy policies place all of the price risk on the dairy farm sector.

Federal dairy proposals, like Foundation for the Future (FFTF), put forward by National Milk Producers Federation (NMPF), dangle the "carrot" of margin insurance, which diverts the attention of Congress away from this worsening farm-to-retail "channel consolidation," and ignores the fact that margin insurance and risk management tools do not function very well within the context of the current milk pricing system.

Rank-and-file dairy producers are concerned about the deep-rooted problems in how their milk is marketed and how the price they are paid is "discovered" and then "set" by the federal orders.

Safety nets and risk management tools are valid parts of future dairy policy, but they will not substitute for fixing the broken milk pricing system.

Poor price discovery

While some organizations have focused their efforts on government-mandated supply management proposals, and DPAC has participated in those discussions and in the funding of the economists' report, DPAC's primary target is milk pricing.

Of particular concern is the lack of market transparency, which allows a handful of influential traders on the Chicago Mercantile Exchange (CME) — who trade less than one percent of the cheese and less than two percent of the butter — to, in effect, set the price paid for all milk at the farm gate. This is the beginning of a poor price discovery process.

The weekly USDA NASS Survey merely captures those CME product prices and then introduces a four to six week time-lag by using these values in the federal formulas for class and component pricing.

Meanwhile, the gyrations on the CME — as we have witnessed over the past few weeks, months and years — can be timed to suit individual agendas.

This volatility often defies reason (as we have seen throughout the latter part of 2010 into 2011), and it not only hurts producers, it can also pressure small to medium-sized processors by driving prices up quickly for sale and driving them back down for product inventory build-up, which can devalue small supplier inventories practically overnight.

The CME daily spot market for “surplus” cheddar and butter are at the core of the challenges facing the nation's dairy producers today. Even the Government Accountability Office (GAO) concluded in 2007 that the Exchange is “vulnerable to manipulation.”

That was the same year that the misreported powder prices on the NASS Survey cost dairy producers an estimated \$50 million, or more, over a period of 11 months.

Congress and USDA have not yet taken the necessary steps to implement the *daily* electronic reporting of dairy product sales (like for beef and pork), which was authorized for dairy in Section 1510 of the 2007-08 Farm Bill, with the words “more frequent reporting.”

Daily reporting of product sales would dilute the influence of the CME on the producer pay price for milk. Furthermore, Section 1510 also authorized quarterly auditing instead of annual auditing. This would reduce the length of time and impact in which a reporting mistake could affect the federal order class and component prices.

For the dairy farmer, price discovery works like this: The truck picks up the milk every day or every other day, and the producer finds out two to four weeks later what he will be paid for it. That price will depend on how the milk was used, and it will depend on how the big traders “priced” a few “market-clearing” products (0.4% of cheese and 1.8% of butter) on the CME four to six weeks before that.

While most agriculture commodities are priced in the present or future — with buyers and sellers sharing the price risk — milk, on the other hand, is priced in the rear-view mirror and the producer has all the price risk.

The federal orders use product price formulas to set minimum class prices, and these formulas include four arbitrary “make allowances” that are embedded in the product price formulas (totaling around \$2.77 per hundredweight).

Each of the four “set” margins is deducted from the product value to cover plant costs incurred by processors and cooperatives for making the butter, cheddar, nonfat dry milk, and whey.

Having “make allowances” that are set by USDA, and can only be changed by a two- to three-year hearing process, leads to manufacturing decisions that may or may not be based on the market.

Nowhere can producers go on a given day to see what their product — milk — was worth in the marketplace. We would challenge the House and Senate Agriculture Committees to name another agriculture commodity that lacks this timely information or is priced with such a tremendous time-lag or is priced according to utilization among four classes. All of these factors, together, allow quite a bit of “maneuvering” until the final price is calculated and announced.

This poor price discovery fuels the trend toward concentrated market power, which reduces competition and erodes the producer’s share of the consumer’s dairy dollar.

Dairy Markets: global, national, and regional

Dairy markets are three-pronged: global, national and regional. DPAC seeks dairy policies that do not further concentrate the market power, which happens when policies are nationalized and centralized as one-size-fits-all. Instead, DPAC supports policies and pricing methods that encourage free enterprise, spur innovation, position the U.S. to be a consistent supplier of dairy products on the world market, and are geared toward revitalizing competition.

DPAC is concerned that policy proposals, like the National Milk Producers’ Federation (NMPF) Foundation for the Future (FFTF), are not looking for substantial change in the milk pricing system nor looking to get involved in world markets, other than to assess producers to fund export enhancement discounts.

The U.S. dairy industry would benefit from being a consistent supplier in the world market with products the world wants. In addition to providing marketing opportunities, this is also a

way to increase the domestic competitiveness of the U.S. dairy industry as a deterrent to imports that otherwise further reduce U.S. market share.

Without a long term change in the current pricing system, the U.S. dairy industry can at best grow 1% per year and at worst lose 20% of its current market share as imported dairy proteins would continue to chip away at our industry, while we would lose export opportunities at the same time.

We have only to look at the current disparity between world market prices for dairy products compared to U.S. “market” prices to see that the current federal dairy policies have not served the dairy industry or its farmers in the increasingly global marketplace.

Reliance on export enhancement funds to move product instead of making and *marketing* products the world wants, is not a solution. At times, this discounted product can compete with and defer previous sales orders by consistent world market suppliers.

The U.S. lags behind other nations, like New Zealand, when it comes to making – *and marketing* – products that foreign – *and domestic* – buyers want. This is in part due to the longstanding policy of product price supports. It is also due, in part, to the lack of incentive to innovate and make products (type and quality) the market wants.

For example, the world markets trade skim milk powder (SMP). The U.S. makes very little SMP in relation to the predominant manufacture of nonfat dry milk (NFDm).

The difference? SMP has a standardized protein content (34%). NFDm is not as consistent in protein content as the standard is 34 to 37%. Often, NFDm contains more protein than SMP and must be blended with lactose to achieve the 34% protein content. Yet NFDm is typically priced lower, especially on a protein basis. There are also reports that U.S.-produced NFDm does not always meet the international customer’s specification for quality, which may be higher than the USDA CCC specification for government powder purchases under the Dairy Product Price Support Program (DPPSP).

NFDM production is supported by the DPPSP, whereas SMP production is not. For decades, the U.S. dairy industry has been geared—and plants have been built—around the model of making and storing government-spec NFDM as a milk-balancing service, and a “make allowance” is deducted from the NFDM price before that value is used in the milk pricing formulas.

The U.S. dairy product lag is also due, in part, to the industry’s reliance on New Zealand’s Fonterra to market U.S. milk powder internationally. Some proprietary plants and cooperatives have been successful in doing their own international marketing. Future dairy policy must encourage, not discourage, more strides in the area of U.S. marketing to international buyers.

Why is this so important to the U.S. farm milk price? The federal dairy support price is the equivalent of \$9.90/cwt. That price is far below—at least 35% below—any dairy farmer’s breakeven cost of production, even if we use a very conservative 2009 cost of production between \$15 and \$17/cwt.

During 2009, the support price, even though it was raised by Congress for six months, was inadequate to cover the extreme income loss experienced by dairy farmers. At the same time, government purchases created a double-whammy where the farm-gate milk price in the U.S. has been far slower to turn around compared with other nations: The U.S. – in effect – balanced the world supply by building inventories that lengthened the period of depression for U.S. dairy producers.

DPAC applauds NMPF for recognizing this and for including in the FFTF the elimination of the Dairy Product Price Support Program (DPPSP). The American Farm Bureau Federation (AFBF) also adopted a policy resolution recently to eliminate these price supports.

Market power

While DPAC and other producer organizations agree with NMPF’s proposal to eliminate the product price supports, there are concerns about other main parts of NMPF’s FFTF because the plan ignores some key issues, further entrenches the commodity mindset, and concentrates more power to the centralized system that already controls the current federal order pricing system.

While it is true that milk is a commodity, it is also true that all farm commodities are today driven by value-added opportunities.

In corn (ethanol) and beef (new products like the flat-iron), for example, recent value-added products are reflected in the competitive market of those commodities as a function of supply and demand.

The dairy industry, on the other hand, keeps value-added opportunities in a separate “box.” At the same time, there is no daily “market” available for milk as a commodity like for corn, soybeans, and livestock. There is also no true daily “market” available for the products made with milk.

NMPF states that its FFTF will include a federal price reform piece, but the details of that piece are not finished or available for review.

The main focus of FFTF is the margin insurance that is coupled with the production management piece. Both of these main pieces are based on milk margins (a national milk price minus a national feed cost).

NMPF promotes FFTF as something “dairy farmers need right now.” However, through producer surveys and over 100 meetings in 2010 with grassroots producers, producer organizations, industry sectors, and experts, DPAC has determined that the issues surrounding the current milk pricing system are far more important to producers than the production management or margin insurance, which can serve to “mask” the core problems in this industry.

DPAC is also concerned that if these policies are adopted by Congress, there will be less commitment by Congress, NMPF, and dairy

leaders to do the tough work in the area of market transparency, price discovery, and federal pricing reform.

Value of 100 lbs of milk?

We all know milk at the farm level is priced per 100 pounds (cwt) and blended according to the percentage of utilization among four federal milk classes. But there are a multitude of dairy products made from 100 pounds of milk, and basic calculations may not sufficiently represent the pricing efficiencies that are available to manufacturers (and cooperatives), where byproduct cream, whey, and other components of milk are used to produce additional products from the same 100 pounds of original farm milk.

Product yield calculations can also vary and be controversial. They vary not only by plant processes but also in the way experts say they can be calculated (fat basis, other solids not fat, protein). Plus, there are the byproducts that flow from the manufacture of one product to the manufacture of another product.

Following the flow of milk components is extremely difficult, and it has changed quite a bit in the past 10 to 20 years. For example, dry whey and whey protein concentrate are products that have more value in the marketplace today than 10 years ago, and they are made with the whey byproduct of cheese manufacturing.

And yet, the “make allowance” for whey — which is one of four “make allowances” embedded in the federal price formulas and subsequently deducted from the class and component prices paid to producers — created a situation in the first quarter of 2009, whereby producers were charged outright for the amount of “other solids” in their milk.

This occurred from December 2008 through March of 2009 because the

NASS Survey whey price at that time was less than the arbitrary “make allowance.” While this negative value was being deducted from the federally-regulated minimum class and component prices paid to farmers, export sales of whey protein concentrate were above the NASS Survey price, and the U.S. was also importing comparatively high levels of whey protein concentrate and dry whey, along with milk protein concentrate, suggesting that whey and whey protein had value and demand at that time.

Why then did dairy farmers have to pay the whey drying cost (make allowance) in excess of the NASS Survey whey value? When the NASS Survey price went below the “make allowance,” it should have been a “wash”: No value paid to producers for the other solids components and no deduction either.

Another example of missed “value centers” in a hundredweight of milk is ice cream mix production, which utilizes cream that is a byproduct of bottling 2% or skim milk for drinking.

And yet another example is the diminishing importance of cheddar cheese — an aged and storable product — in the marketplace, compared with the increased production and popularity of mozzarella, pizza cheese and other fresh Italian cheeses, which are made-to-order and go unreported.

Furthermore, soft products, like yogurt in its ever-increasing forms and formulations, is growing in production and value, but is not reported.

Add to this, the fact that the producer pay price for manufacturing milk forfeits the arbitrary “make allowances” that are set by USDA for making storable commodities: cheddar, butter, nonfat dry milk and whey.

The combination of the “make allowances” and the government support price purchases tend to encourage expanded production of certain “low risk” products based on these “program” factors, regardless of what products the market wants. The inventory then suppresses the price paid to producers, which does not acknowledge the value of other market uses for milk.

Meanwhile, federal orders set some of the milk pricing factors for the expressed purpose of maintaining a consistently abundant supply of fluid drinking milk for consumers (defined as ‘more than enough’).

These are some of the market factors that affect the movement and usage of milk throughout the supply chain from the farm to the consumer.

Since at least 2006, dairy market experts and economists have been talking about the “archaic” milk pricing system being in need of an overhaul. It is generally agreed, throughout the industry, that price discovery is among dairy’s biggest challenges.

For DPAC, market transparency and price discovery are the foremost focus, and mandatory daily electronic reporting is viewed as the cornerstone of that focus.

Diluting CME influence on farm-gate milk price

According to a DPAC survey in print and online, in which roughly 800 dairy producers from 23 states chose to participate, there was universal agreement that it’s high time to reduce the influence of the CME surplus cheese market as the primary driver of the farm milk price (including the Class I base).

Daily electronic reporting would make this possible by reporting negotiated trades on a daily basis, much like the beef and pork industries, where USDA releases daily reports detailing the price and sales volumes for the wholesale value of all retail cuts.

The University of Wisconsin and FAPRI published several dairy policy briefs in 2010. One dealt with the CME issue with this observation:

“Product price formulas rely on wholesale prices for dairy products that are collected and reported by USDA’s

National Agricultural Statistics Service (NASS). While this reporting is mandatory, NASS only requires reporting of prices for spot market sales, which represent less than 20 percent of butter production and less than 40 percent of cheese production. Moreover, because prices for most butter and cheese transactions are pegged to the thinly-traded Chicago Mercantile Exchange markets, even spot market sales prices may not consistently reflect broad supply and demand conditions.

This is a crucial statement. If NASS product prices do not reflect broad supply and demand conditions, then the dairyman’s milk price may not be accurate. This is because the CME drives the spot market sales NASS collects weekly.

Daily reporting would dilute the CME’s impact on dictating price. Daily reporting of actual sales would give a broader view of supply and demand factors and the wholesale value of dairy products on a given day. In addition to daily reporting, more plants should be included in the reporting. Also the list of reported products should be expanded. All three of these reporting improvements — frequency of reports, number of plants reporting and number of products reported — were adopted as policy resolutions by the delegates of the American Farm Bureau Federation at its National Convention in January 2011.

Many state dairy producer groups have adopted similar resolutions in 2010-11.

In DPAC’s 2010 survey of dairy farmers: Market transparency was ranked in the top three concerns by 70% of respondents.

Market volatility, concentration, and future profitability were ranked in the top three by 55 to 61% of respondents.

Over-production was ranked in the top three concerns by 28% of respondents.

By a wide margin: Removing or reducing the influence of the CME spot market (by taking the NASS survey to the next level via daily electronic reporting) was ranked in the top three priorities by 77% of survey respondents.

Another dairy policy area that garnered many votes was eliminating dairy product price supports in favor of solutions that encourage innovation to move milk to its highest value use.

Nationwide, 77% of respondents favored eliminating the price supports. In the West, 71% of respondents favored this, 15% were opposed and 13% were unsure. In the Midwest, 93% of respondents favored eliminating the price supports, zero were opposed and 7% were unsure. In the Northeast, 79% of respondents favored the elimination of price supports, with 3% opposed and 17% unsure. And in the Southeast, 56% favored eliminating the price supports, with 12% opposed and 31% unsure.

Cornerstones for change

DPAC has identified these cornerstones for change that are critical for future dairy policy:

- **Improve market transparency**

- Implement mandatory electronic reporting of dairy product prices on a DAILY (not weekly) basis. (Section 1510 of the 2007-08 Farm Bill).
- Audit price reporting on a quarterly (not yearly) basis (Section 1510 of 2007-08 Farm Bill).
- Audit and make mandatory the current dairy product inventory reporting conducted by USDA NASS.

- **Expand price discovery**

- Expand the product price reporting to include more products in order to reflect **broad supply and demand factors.**

- Current weekly NASS Survey reporting is limited to cheddar, butter, nonfat dry milk, and whey.
- American style Cheddar is the current driver of the farm-gate milk price, but the price used by USDA is 98% correlated to the 0.4% of product traded on the Chicago Mercantile Exchange (CME).
- Italian-style cheeses (mainly mozzarella) are a fast-growing product sector that has surpassed American style cheddar, but those prices and sales volumes are not currently reported. American-style cheese comprises less than 40% of total cheese production today.
- Yogurt, and other soft dairy products, represent another fast-growing value-center that goes unreported.
- **Simplify the milk pricing system** (The majority of producers and others believe the current milk pricing system is too complicated and is broken.)
 - **Simplify the number of milk classes,** and establish a competitive pay price system that encourages movement of milk to its highest value use.
 - Milk pricing methods should encourage competitive market-based manufacturing decisions and help producers develop the concept of “producing for a market.”
 - As innovation leads to more types of dairy products, it is increasingly difficult to “pigeon-hole” these products (and their value) into a multi-class pricing structure. This four-class system based on product price formulas tends to allow even more marketplace value to escape from the producer’s farm-gate milk price.

- **Options include:**
 - A 2-class system where all fluid (drinkable) products are Class I and all other products are Class II.
 - A 2-class system where Fluid and soft products are Class I and all storable manufactured products are Class II.
 - A 1-class system where all uses compete for milk. In this scenario, domestic utilization could comprise a percentage of the farm-gate milk price while exported products could comprise a different percentage of the farm-gate milk price. This would have a “stabilizing” effect as the global marketplace is quite volatile, and it would allow the U.S. to be competitive in the world market while acknowledging the high percentage of domestic usage. New Zealand prices milk this way, but their domestic utilization is low while their export utilization is high.
- **Encourage competition & innovation**
 - Establish a competitive pay price system and **move away from the current end-product-pricing formulas**, which “pigeon-hole” the milk and are reliant on a thinly-traded CME to set the product prices that are used in the formula calculations.
 - The CME is not a true market. It does not reflect broad supply and demand factors, has few traders, allows traders to trade against interest (where net buyers can sell and net sellers can buy), and it is vulnerable to manipulation.
 - Furthermore, the current method of using these CME-driven product price formulas includes arbitrary “make allowances” that are set by USDA to guarantee a margin to processors and cooperatives whether or not they are making products for the market or for storage or for sale to the government.
 - The “make allowances” that are embedded in the product price formulas lead to “low risk” manufacturing decisions that ultimately put the market price risk solely on the backs of the dairy farmers.
 - Competitive pay price options for milk and its components (instead of product price formulas) would encourage movement of milk to its highest value use.
 - For example: Corn’s primary use is as an energy source in animal feed rations. However, corn is also processed into a large number of food and industrial products, thus the demand for corn at the farm level is derived from the demand for each of these uses and the price of corn is a function of supply and demand from all competing uses.

- Furthermore, consumers want local food, and they have a vested interest in having a geographically distributed milk supply instead of a concentrated milk supply. The complexity of current federal pricing facilitate the concentration of market power and thus interfere in the ability of dairy producers to truly access local market premiums.
- Future federal dairy policy should also include ways to identify locally-produced or U.S.-produced dairy products so both farmers and consumers can benefit from having a choice.
- **Redistribute price risk, with policies that:**
 - End the government dairy price support program and the guaranteed “make allowances.”
 - Encourage competitive market-based manufacturing decisions and market development to be a consistent supplier of products in the world market... And market those products without relying on other countries to market them for us and without relying on farmers paying to subsidize those export sales.
 - Encourage marketing models around the concept of “producing for a market” as a means of sharing price risk, achieving a price into the future, and managing milk production.

Analysis of NMPF’s Foundation For the Future (FFTF)

As NMPF moves forward with its Foundation for the Future (FFTF) plan, DPAC sees some potential areas of agreement, but also concern.

Market Stabilization Program

Under NMPF’s FFTF, the supply management piece is proposed as a Dairy Market Stabilization Program (DMSP), which would penalize producers’ pay price whenever the *national* margin between milk price and feed cost reaches \$6 per cwt (or less) for two months.

The penalty at the \$6 *national* margin is that producers, nationwide, would not be paid for 2% of their milk base (if shipped); no payment for 3% at the \$5 margin; and no payment for 4% at the \$4 margin. If the “penalty milk” is shipped anyway, those dollars would still be paid by processors, but instead of going to producers, the payment for “penalized” milk would go into a centralized cheese-buying fund to buy cheese for donation to food assistance programs.

During this time of “assessment” at the 2%, 3%, or 4% of base production levels, not only is the federal order minimum price on that milk forfeited by all producers, all market premiums (local premiums, specialty premiums, component premiums, quality premiums, even state-mandated premiums consumers pay to support their region’s dairy farms) would also be forfeited, as would the differentials that currently protect the Class I fluid markets.

This means producers of milk with higher solids content and/or higher quality would pay a higher relative penalty because they would forfeit the base price plus their market-driven premiums on the “penalty” percentage of their production.

This scenario also could be quite disruptive to regional markets because, in effect, it concentrates even more market power at a *national* or centralized level in a way that facilitates more rapid consolidation and shifts in where milk is produced and where plants are located, further jeopardizing the distribution of local milk supplies and plant locations in various regions of the country.

Example #1 – Market premiums in the MidEast / Midwest

- Dairy producers who serve the growing markets for specialty cheeses would pay a higher penalty when *national* margins would trigger the DMSP. This is due to losing both the base portion of their milk price plus whatever premiums they are able to secure from those markets, which may still need just as much milk.
- The dollars collected from this penalized milk would be used to buy commodity cheese for donation to food assistance programs. Thus, in effect, specialty cheese processors, and other manufacturers that are cultivating markets and paying premiums to procure local milk or milk of a specified quality, would be subsidizing the purchase of commodity cheese they may or may not benefit from.
- **This entrenches the commodity mindset and further erodes the farmer’s share of the consumer’s dairy dollar.**
- It also interferes with manufacturing decisions by rewarding commodity product manufacturing at the expense of producer value centers that come from cultivating and serving value-added markets.
- If those specialty cheese processors want to attract local supplies, or a specified quality and component level, of milk to their plants — but the premiums on a portion of that milk must go to the “commodity cheese-buying fund” instead of going to their shippers during times of margin stress... doesn’t this, in effect, centralize and further concentrate the market power?

- If those markets need the milk and producers in the region cut back because they are not receiving the price or the premiums for that milk during a time of tight margins, the milk will be brought in from somewhere else. This would totally disrupt those markets.

Example #2: Fluid markets – Southeast (and to some degree Northeast):

- Producers in fluid milk markets, particularly the deficit markets of the Southeast (and to some degree the Northeast) would not only pay a higher penalty into the cheese buying fund, they would also have the cost of bringing milk into their region as they cut back production due to the penalties.
- Federal orders like the Southeast (and to some degree the Northeast) are milk deficit areas because they have less milk output in relation to nearby consumers for fluid markets, and they experience higher input costs.
- DPAC believes consumers are well served by policies that make economic sense and policies that allow local producers to compete on a level playing field with milk from other orders.
- This is also a carbon footprint issue and a consumer preference issue.
- Consumers, as well as regional economies and the environment, are well served when dairy policies recognize the importance of a geographically distributed milk supply of locally available milk versus a concentration of milk production into fewer milk sheds.
- In a functioning market, the farmers who are producing milk in orders that are considered milk-deficit should be able to gain a price advantage that is at least equal to the cost of transporting milk from other orders into their order to overcome that deficit.

- Orders with excess production could gain the fluid class price advantage with their manufacturing class milk by moving it to the deficit orders; however, the cost to ship the milk should be borne by the processor and would thus be an added value above the fluid Class I prices.
 - **The point is:** If the processors had to pay the freight to ship milk into a deficit order, they would be more inclined to pay fluid premiums to local producers at least equal to the transportation costs for bringing in supplemental milk.
 - **Currently, the system doesn't work that way** as the movement of milk, pooling regulations (or lack thereof), diversions of qualified milk back to other markets while still being priced in the deficit market, transportation credits, etc. centralize the market power and create a situation by which local producers in milk deficit orders actually lose this market value and, in turn, lose more of their market share to the distant milk.
- The way producers would be penalized under NMPF's DMSP affects the distribution of not only voluntary over-order premiums, but also state-mandated over-order premiums such as in Pennsylvania, where consumers must pay, by law, a minimum fluid milk price at retail, which includes set costs and margins for retailers and processors as well as, currently, a 25-cent per gallon premium intended by law for producers.
 - In times of tight margins, the state-mandated premium is increased to assist producers. But, if those producers must forfeit payment for 2%, 3%, or 4% of their milk via the *national* margin trigger, then that state-mandated fluid milk premium would go to the cheese-buying fund run, in effect, by NMPF.
- Similar scenarios would affect the Southeast, where transportation credits and diversions have already reduced the fluid Class I utilization, in effect lowering prices to the local farmers in order to pay to bring more milk into the region.
- It has been said that the USDA federal order hearing process should be used to “fix” such regional problems if NMPF’s plan is adopted by Congress, however, NMPF and its member cooperatives will control those “fixes” as they have historically had the most “say” in the federal order hearing processes that determine these rules.
- Grassroots producers can’t very well access this federal order hearing process, and they do not vote on the outcome of these hearings due to “bloc voting” by the cooperatives. This has become a vicious circle, and the NMPF FFTF *national* plan would further compound the issues.
- Another net result is fluid bottlers would see the premiums they pay to local shippers go to the centralized cheese-buying fund in times of margin stress. This would disrupt those markets and cause producers in those markets to lose even more value and market share.

Example #3: Expansion markets in the Western States:

- Western dairy producers have also indicated they are looking at marketing products the world wants instead of relying on discounts paid by dairy farmers to move inventoried product into the world market.
- When the U.S. government serves as a guaranteed price support purchaser, and when the pricing formulas embed “set” make allowances, innovation and creativity are stifled.
- There is support in parts of the West for ending these policies. Incentives such as low interest loans could help retrofit plants to make products for the market, not inventory.
- However, NMPF’s FFTF would reduce net exports compared with baseline projections, according to the analysis performed by Drs. Mark Stephenson and Chuck Nicholson. The very small net effect on the all-milk price would come from FFTF spending collected monies on demand enhancing activities, which is mainly the purchase of cheese for donation through non-commercial channels.
- Meanwhile, under the DMSP part of FFTF, when milk is shipped from areas of surplus to deficit areas, the only one making the money are the movers of the milk. The economic cost is borne by producers in the deficit area. If they are told to produce two percent less, they also have the cost of paying to bring

additional milk into their area. A better system would be requiring processors to truly bear the cost of that transportation or have the option to provide market premiums to encourage the production of additional milk in the deficit area.

These examples are some of the questions and concerns DPAC, and others, have expressed regarding NMPF’s Foundation for the Future. By nationalizing the market stabilization process, with no sensitivity to the still-regional aspects of milk marketing, this plan, in effect, makes it more difficult for producers to innovate and cultivate specialty markets per the wishes of consumers wanting to buy local milk and dairy products.

The centralized approach of FFTF limits U.S. export opportunities and at the same time affects the regional distribution of milk markets throughout the country. Thus it has a “national” focus that does not fully consider global and regional aspects.

Regionally, FFTF has the potential to disrupt markets and milk flow by forcing all producers to forfeit all of their pay price on a percentage of their base to — as NMPF puts it — “correct market imbalances and improve producer margins.”

This statement assumes (or prefers) milk market “balancing” that is 100% national, and places an undue government-sanctioned burden on regions that are already losing market share. This could, in turn, also affect plant locations in currently competitive regions that cultivate new markets.

If margins trigger the DMSP, then plants that continue to need milk to satisfy their markets would pay to bring in surplus milk from other market areas at a time when their shippers may be forced to cut back the production they are not being paid for.

While this does open an outlet for surplus milk, and gives a signal to cut back production, it also disrupts regional markets and makes it more difficult to be a consistent supplier in the world market. Both of these outcomes can result in the transfer of value and market share from one part of the country to another and from the U.S. to other nations.

Margin Protection Program

The base level of margin protection within NMPF's FFTF is projected to "kick-in" at the \$4 margin of milk price over feed cost. At that level, the Dairy Producer Margin Protection Program (DPMPP) would not have triggered in 2003 or 2006, and would only have triggered in eight months during 2009.

This level could be triggered by high feed cost, low milk price, or a combination. One aspect of this "margin" is the volatility at new price levels for feed ingredients. While ethanol subsidies are a contributing factor to the feed cost side of the margin, so is the increased level of grain exportation as other countries need grain and U.S. dairy and livestock producers compete for that grain. The exchange value of the U.S. dollar can further complicate that picture.

Considering these variables, some have suggested solutions such as a "grain reserve" be considered to mediate some of the volatility to both users and growers of grain.

Meanwhile, NMPF's FFTF seeks to use margin triggers for both the DPMPP (margin protection) and DMSP (market stabilization).

While the DPMPP base protection is projected to use a \$4 margin trigger at 90% of the five-year, locked-in base, the DMSP would at the same time penalize dairy producers by forcing them to forfeit payment on 4% of their production as determined by their rolling base.

The FFTF website has a functioning calculator for the DPMPP so producers can calculate how the protection would work for them. But the website does not have the corresponding calculator for the penalty side (DMSP) at those same margin triggers. Dairy men need to know the net effect of both sides of the equation, and at this point, dairy

producers do not know or understand much about this program.

Margin insurance tools (like LGM-Dairy) are useful and already available to dairy producers for managing their risk, however, a national margin protection plan—using national costs, prices and margins—is inflexible and does not substitute for the more pressing price discovery issues.

The value is in the market—as clearly shown by the erosion of the farmer's share of the consumer's dairy dollar as well as the missed opportunities of new product development and supplying international buyers.

In fact, a national margin protection program puts the cart before the horse as risk management does not function as well for dairy, as in other agriculture sectors, because dairy lacks a true market and is priced by a complex four-class system.

It is important to realize that the DPMPP is a *national* program. According to American Farm Bureau Federation analysis, these margin payments are activated when the *national* margin — the difference between the national average all-milk price and the nationally-calculated feed cost from the formula — drops below a predetermined margin level, or trigger.

However, individual producer margins may be above or below the predetermined national margin.

Moreover, dysfunctional markets and poor price discovery, along with the complex federal pricing system, make a national margin protection plan and national market stabilization plan vehicles for further concentration of market power.

As for the supplemental margin insurance, which producers could "buy-up" in addition to the base catastrophic coverage, the DPMPP only allows individuals to insure against *national* margin risk, not individual farm risk.

Unlike LGM-Dairy or other risk management strategies, this national margin makes it more

difficult for producers to make individual decisions and use individual feed rations in the program.

The already available LGM-Dairy tool allows some flexibility for producers to choose default feed programs or their own margin levels to the degree they want to manage their feed cost risk (purchased feeds or all feed). They are also able to select deductibles and coverage months to balance the cost of the coverage with the benefits.

Under NMPF's proposed DPMPP, these functions are set nationally and according to the producer's base, which is the highest production level in the previous three years and is locked in for five years.

New operations are also treated differently, and there are questions about ways in which integrated corporate models could funnel future expansions through a "new producer" modified base.

Summary

DPAC is one of 15 organizations that helped fund the development of the economic model used to analyze NMPF's FFTF along with two other stabilization plans. The September 2010 report by Drs. Mark Stephenson and Chuck Nicholson, showed very little benefit over baseline in regard to producer pay price or net farm income. Their analysis did, however, show that NMPF's FFTF program could flatten the volatility by removing some of the peaks and troughs.

Perhaps the best hope for dairy producers is the ability to "produce for a market" and develop a marketing mindset instead of a commodity mindset when it comes to evaluating future dairy policy.

FFTF does not address these concepts, and in fact, moves the industry toward more of a commodity mindset with government-run nationalized margin protection and market stabilization programs as the safety net.

Since dairy markets are global, national and regional, the challenge is to participate as a consistent supplier in the global market — including competing for domestic markets by making products these markets want — while at the same time recognizing regional markets are still part of the national picture and could become more so, given consumer desire for local food and for food that has a reduced carbon footprint.

In addition to these questions on the NMPF plan for "market stabilization," DPAC will continue working to assure market transparency, price discovery and price reform are key components of 2012 Farm Bill dairy policy.