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Chairwoman Stabenow, Ranking Member Roberts, Members of the Committee:

Thank you for this opportunity to submit this testimony on behalf of the members of the Midwest Dairy Coalition regarding our perspective on federal dairy policy reforms needed in the 2012 Farm Bill.

Historically, the dairy title of the Farm Bill has been one of the most challenging parts of the bill to write. This is related to the complexity of dairy markets, the volatility of milk prices, the importance of dairy production in all regions of the country, and the wide regional differences in herd structure and dairy manufacturing.

There is a great deal of agreement in the dairy industry that current dairy policies were not sufficient to deal with extreme economic stress suffered by dairy farmers in 2009. The combination of low milk prices and high input costs experienced in 2009 resulted in an unprecedented loss of equity for dairy farmers nationwide. Prices have recovered somewhat, but remain very volatile and are far short of the levels necessary for producers to be economically sustainable. Even if milk prices recover further, it will take years for farmers to recoup the equity they lost during 2009. Dairy farmers cannot withstand a repeat of 2009 conditions. The economic safety net must be improved.

The National Milk Producers Federation has provided a great deal of leadership in fostering discussion within the industry about needed dairy policy reforms. The result of this multi-year dialogue has been the Foundation for the Future, a far-reaching package of dairy policy reforms.

Because the Foundation for the Future (FFTF) package has been the primary focus of dairy reform discussions of Capitol Hill, this testimony will focus on the Midwest Dairy Coalition's perspective on the FFTF proposals.

Counter-Cyclical Safety Net:

Preserve and Improve the Milk Income Loss Contract (MILC) Program

It is critical that a credible counter-cyclical safety net program be in place, structured in a way that is meaningful to a majority of dairy farmers. We believe this goal would be best achieved by modernizing and improving the Milk Income Loss Contract (MILC) Program.

The strong regional dairy tensions of the late 1990s related in large part to regional differences of opinion about the appropriate way to structure counter-cyclical assistance to dairy farmers. At that time, the strongest disagreements were between the Northeast and the Upper Midwest. In the 2002 Farm Bill, the dairy interests of the two regions were able to work together toward the creation of a new program, called the Milk Income Loss Contract (MILC) Program, as a compromise approach to address the needs of dairy farmers in both regions, and other regions as well.

In fact, the creation of the MILC program in the 2002 Farm Bill and the strengthening of the program in the 2008 Farm Bill has served as a peace-keeping mechanism that has helped reduce the regional tensions that had greatly complicated dairy policy discussions in the 1990s.

Since its creation, the MILC program has been a critical safety net program for the nation's dairy producers. Indeed, the dairy economic disaster of 2009 would have been far worse for most dairy farm families if the MILC Program had not been in place. Congress should build on the successes of the MILC program by improving it, not eliminating it.

The NMPF Foundation for the Future Plan proposes to eliminate the MILC program and the Dairy Product Price Support Program (DPPSP), and to use the baseline funding from those programs to create a new catastrophic margin insurance program. Under the new margin insurance concept, a catastrophic, base level of protection would be fully paid by the federal government, without any payment limits or limits based on volume of milk production. The NMPF plan would then allow farmers to purchase higher levels of coverage, with a partial subsidy on premium.

We believe that NMPF has done a good job in identifying margin (defined as all milk price minus feed costs) as the appropriate measure of dairy farm profitability, instead of

just milk price alone. However, we do not agree with a dairy safety net approach that would provide a full taxpayer subsidy to all farms for every last drop of milk they produce. Not only would such a policy lead to very large payments to individual large-scale farms, but it would do so by greatly diluting the safety net to the overwhelming majority of dairy farms in the nation. Federal dairy policy should focus on providing a credible safety net for farmers, not for milk production itself.

Therefore we propose to continue the MILC program, but to use the NMPF margin concept to improve the functioning and effectiveness of the program, to reflect the new reality of high feed costs.

Currently, MILC program assistance is triggered when the Class I milk price at Boston falls below \$16.94 per hundredweight, and that target price is modified monthly based on a feed cost adjuster calculation. The feed cost adjuster was added late in the 2008 Farm Bill debate when the reality of high feed costs was just becoming evident. What was considered a decent milk price in the past is now woefully inadequate because of the “new normal” of feed and other costs faced by dairy farmers. But the extent of the low dairy producer margins that would be suffered in 2009 was not yet known when the Farm Bill was being finalized in 2008. As a result, the current MILC trigger formula proved to be inadequate during the 2009 crisis, when high feed costs lead to very tight margins for farmers. To more adequately address times of economic stress for dairy producers, the MILC program should be triggered when dairy producer margins narrow to unsustainable levels.

As has been the case historically, the focus of the improved MILC program should be to maximize scarce federal dollars to provide a credible safety net for the nation’s dairy producers. To do so requires the continued use of reasonable limits on how much assistance individual farmers can receive.

The average dairy herd size in the nation in 2010 was 146 cows, with 90 percent of the nation’s dairy farmers milking 200 cows or fewer. The MILC program should continue the use of a volume cap to target and maximize assistance. However, depending on Congressional Budget Office scoring, the current volume cap of 2.985 million pounds per operation should be increased incrementally in recognition of herd-size growth nationwide.

Figure 1 demonstrates the problems associated with an uncapped margin insurance program as proposed by NMPF as a replacement for a MILC program with a volume cap. The chart compares the actual payout of the MILC program during the period of 2002 through 2009, in comparison to what the payout would have been under the base (fully subsidized) portion of the NMPF Margin Insurance Program. It compares the assistance under the two safety net program approaches for a typical 100-cow farm, 1000-cow farm, and 10,000-cow farm. What it shows is that over the 8-year period of the analysis, a typical 100-cow farm (close to the national average size herd) would have received \$59,000 less in assistance under the NMPF margin insurance base program than that farm received under the MILC program. In stark contrast, because of the unlimited, uncapped

payment aspect of the NMPF plan, a typical 10,000-cow farm would have received nearly \$2.6 million more over the 8-year period under the NMPF base margin program, had it been in effect, relative to what that farm received in the MILC program. All of the money would have come in one year alone, 2009, when a typical 10,000-cow farm would have received a \$2.7 million payment.

In times of scarce federal dollars, it is not good fiscal policy or good dairy policy to be greatly diluting the safety net to the overwhelming majority of dairy farmers in order to subsidize multi-million dollar payments to a small handful of very, large-scale farms. Dairy policy should be focused on supporting dairy farmers not milk production.

In addition, consideration should be given to ways to provide additional margin insurance options to those few producers that exceed the volume cap, whether it is through a buy-up option on top of the MILC program, a continuation of the Livestock Gross Margin- Dairy Program, or creation of a new risk management mechanism. Yet great care should be given in structuring this assistance, because the largest 10 percent of farms produce over 70 percent of the nation's production, a percentage that is rapidly growing. (*See Figure 2*) Any risk management program that creates a large incentive for additional production could be counter-productive and contribute to the problems of price volatility, particularly as applied to these largest herds.

The proposal to improve the MILC program by triggering the program on margin rather than price is not new. In fact, this was the recommendation of Secretary Vilsack's Dairy Industry Advisory Committee (DIAC), whose membership included a broad cross-section of dairy interests, including farmers, cooperatives managers, processors, retailers, and state agencies. In their March 2011 recommendation, the DIAC included the following recommendation, by a vote of 15 to 2:

RECOMMENDATION #11: Continue MILC, with a production cap based on available funds, with two important modifications: (1) use an all-milk income/feed cost margin trigger, and (2) provide an insurance program for production excluded by the cap to provide protection for larger producers.

The breadth of DIAC membership is similar to the multitude of interests that Congress itself must consider in writing farm policy, and therefore its recommendations should be noteworthy to the Committee as a good starting point for discussions.

While the details must be added to flesh out the skeleton of this proposal, based on existing budget constraints, the Midwest Dairy Coalition strongly endorses the structure of this DIAC recommendation.

Federal Milk Marketing Order Reform Proposal:
Not Ready for Prime Time

The broad parameters of the original NMPF Foundation for the Future plank for Federal Milk Marketing Order (FMMO) Reform encompassed reforms that were widely supported across the country, including:

- Develop a pricing system that compensates producers fairly, reduces price volatility, and creates a more dynamic dairy industry.
- Address inequities and inadequacies of product price formulas
- Encourage movement of milk to highest value uses
- Maintain Class I minimum price with pooling of differentials.
- Use a competitive pay price for Class III and eliminate end product pricing formulas.
- The Class III competitive price would be used as the Class I mover
- Maintain Class II minimum price using Class III plus a differential
- Use California Class 4a to price Class IV (maintaining minimum pricing)

In regions such as the Upper Midwest, where an overwhelming majority of milk produced is used in the manufacturing of cheese and other dairy products, there has been a longstanding opposition to the bias in the current federal milk marketing order system against manufacturing milk values as a result of the artificial enhancement of Class 1 (fluid) milk. So while it had been our hope that the NMPF federal order reform proposal would tackle this unfair and discriminatory aspect of the federal order system, Upper Midwest dairy interests were urged to agree to the broad FMMO reform goals, given that the Class I (fluid) milk portion of the proposal would remain static, neither worsened nor improved, for purposes of achieving consensus.

Yet when the final NMPF federal order reform details were added in the final days before its submittal to Congress, it included a new aspect to actually exacerbate and re-ignite the regional division related to the Class I pricing issue.

We strongly believe that this last minute addition has shifted this proposal away from its stated goals of compensating producers fairly and creating a more dynamic dairy industry, to one that widens the regional inequities in compensation to producers and perpetuates an outmoded notion that consumers will pay whatever price necessary to buy bottled milk. This underlying premise is in spite of decades of evidence about the plethora of other beverage options available to consumers.

As described by NMPF's own analysis of their FMMO reform proposal, the national Class 1 price would average 51 cents higher per hundredweight than under the current system. Even though Class I milk represents less than one-third of milk use in the nation, NMPF failed to analyze the impact of this artificial Class I enhancement on the value of the other two-thirds of milk produced in the nation, that which is used for manufacturing, or on the consumption trends of fluid milk itself.

At the request of the Midwest Dairy Coalition, Professors Mark Stephenson of University of Wisconsin-Madison and Charles Nicholson of Cal Poly San Luis Obispo used their complex systems dairy model for an analysis of the total impacts of such Class I

enhancement on U.S. all milk and individual class prices. Their preliminary analysis found that the increase in Class I price has a negative impact on Class III price. The reason for this effect is that the increase in Class I price:

... is pooled to producers and has an initial result of increasing net farm operating income (NFOI). This in turn entices producers to make additional milk, which ultimately is made into more dairy products (including cheese) and puts downward pressure on dairy product prices. (The impact on product prices varies over time, but the average effect is about -1.25 cents per pound of cheese with a \$0.50 increase in Class I price and -2.57 cents with a \$1.00 increase) Lower dairy product prices ultimately are translated into lower Class II and Class IV milk prices, which have a negative impact on the blend price. The impact of the increase in the Class I price is a reduction in average Class III price of 12 cents (for the \$0.50 increase in Class I price) and 26 cents (for the \$1.00 increase in Class I price).

These reductions in manufacturing milk prices as a result of artificial enhancement of Class I prices are stated in terms of national averages. For regions like the Upper Midwest, where an overwhelming majority of the milk is used for manufacturing purposes, the downward pressure on manufacturing milk values related to the Class I enhancement proposed in the NMPF federal order reform plan are far more severe.

In addition, the analysis indicates that because the MILC program is currently triggered off of the Class I price at Boston, the FMMO reform proposal (without consideration to the other possible aspects of dairy policy reform) would artificially enhance the Class I price at Boston and result in a corresponding nationwide reduction in assistance under the MILC program. This reduction in the producer safety net would take place even though the Class I enhancement in the NMPF federal order reform proposal would not actually result in any increase in net farm operating income, because of its downward effects on manufacturing milk values.

“As a result,” the analysis describes, “net farm operating income is actually decreased for smaller farms and increased for the largest size category.” The largest farm size in their model is over 2000 cows, a category which represents only about 1 percent of nation’s dairy farmers but more than 30 percent of all milk production.

The analysis further indicates that an artificial enhancement of Class I price of 50 cents would result in a 0.3% drop in fluid milk sales and a Class I price increase of \$1.00 would result in a 0.6% drop in fluid sales. This is based on the long-standing analysis that consumers have far more beverage options than in the past, and are therefore more inclined to reduce their purchases of fluid milk as prices increase, in favor of other options.

There are a few common truths about the federal milk marketing order system. First, it is very complex and very few people, even within the dairy industry, fully understand it. Every proposal that has sought to simplify the system has actually resulted in more

complexity. Every overhaul of the system has required further revision through USDA's federal order administrative hearing process, once the full implications of the overhaul are better understood.

True to history, the NMPF proposal that originally sought to simplify the FMMO system is in reality quite complex, with details and implications that are not well understood, even within the dairy industry.

It is inappropriate to ask Congress to legislate the details of such a complex proposal, because doing so will require the dairy industry to return to Congress to fix the system, once the implications are fully understood. This is exactly the reason that Congress established the federal order hearing process through USDA's Agricultural Marketing Service, to provide a process for reforming the pricing system, without the need for constant legislative changes. Though the federal order hearing process has in the past been cumbersome, Congress recognized this problem and included new streamlined procedures for the federal order hearing process in Section 1504 of the 2008 Farm Bill.

Growth Management:

A Tool to Reduce Price Volatility and Federal Government Costs

The volatility in milk prices has become a much more common reality in dairy markets over the last decade. This, combined with volatility in input costs such as feed, has exacerbated the boom and bust cycles experienced by dairy farmers.

Most industries work to target production levels to meet consumer demand, in recognition that over production will result in a devaluation of their products. Similarly, periodic over production of milk is also a problem in the dairy industry, because the price signals are often too late to encourage farmers to reduce production. Also, production management demands a collective effort to secure the necessary results.

Without some federal policy to encourage dairy farmers to work collectively to address supply/demand imbalances, milk price volatility and profitability will continue to be a problem for all dairy farmers.

In addition, the volatility of milk prices has also contributed to the cost of federal countercyclical programs, such as the Milk Income Loss Contract (MILC) program. Economic analyses have shown that many of the various growth management programs discussed in the dairy industry would have the effect of reducing the cost of federal dairy safety net program, by reducing the number of times that prices decline to levels where such programs are triggered.

The Midwest Dairy Coalition supports the establishment of a federal program to help dairy farmers work together to manage growth, to reduce the price volatility that has become so pronounced in the past decade. Such policies must be crafted in a way to allow farmers to modernize their operations and to allow for continued growth.

In Summary-

With respect to the Foundation for the Future package of dairy reforms proposed by National Milk Producers Federation, the Midwest Dairy Coalition:

- Proposes a Modified Version of Counter-Cyclical Margin Program
 - Continue MILC, but improve program by using NMPF's margin concept as the trigger for assistance
 - Continue volume cap to maximize and target assistance, with some increase in cap to reflect increase in herd-size averages nationwide
 - Provide additional risk management options for the small percentage of producers with production in excess of the MILC volume cap
 - Consistent with USDA Dairy Industry Advisory Committee recommendation (#11)

- Opposes Class I Enhancement Aspect of Federal Milk Marketing Order Reform proposal
 - Not consistent with originally stated goals of Foundation for the Future package
 - Increases Class I fluid milk prices (less than one-third of nation's milk) and drives down values of manufacturing milk (over two-thirds of nation's milk).
 - Discourages consumption of fluid milk and drives consumers toward other, less nutritious, beverage options
 - Reduces net farm operating income for dairy producers
 - Interferes with the original, widely supported parameters of federal order reform, which were to simplify federal orders, to move away from end-product pricing and toward a competitive pay price system, to "compensate producers fairly," and to "move to a more dynamic dairy industry."
 - Federal order details should not be legislated, but should be achieved through federal order hearing process, which was revised and streamlined by Section 1504 of the 2008 Farm Bill

- Supports the Principles of the Growth Management Program
 - To help reduce milk price volatility
 - To encourage dairy farmers to work collectively to address supply/demand imbalances
 - To reduce the taxpayer cost of dairy counter-cyclical program
 - Must be crafted in a way to allow farmers to modernize their operations and to allow for continued growth.

Thank you for this opportunity to submit testimony. We look forward to working with the Committee throughout the Farm Bill process.