

**Observations & Responses of the grassroots Dairy Policy Action Coalition (DPAC)
Submitted Sept. 27, 2011**

to Testimony and Questions raised during the
Sept. 8, 2011 Dairy Program Audit Hearing

Conducted by the Livestock, Poultry and Dairy Subcommittee of the
House Committee on Agriculture
Chairman Tom Rooney and Ranking Member Dennis Cardoza presiding

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Hearing Observation:

- I. Acting Deputy Administrator Juan Garcia stated that, "...insurance makes up an important part of the safety net for dairy producers." He referenced two basic insurance models: Livestock Risk Protection and Livestock Gross Margin (LGM). LRP provides protection against unexpected declines in the price of certain livestock while LGM provides protection against the unexpected declines in the margin of the insured livestock product – which includes Milk.

Garcia stressed that USDA "recognizes that volatility and uncertainty affects all producers to a certain extent. Market fluctuations can be particularly dramatic in the dairy industry and we have been very diligent in exercising a broad range of program authority to help dairy producers across America."

DPAC Response:

Dairy producers do not have a functional market and lack good tools for managing risk as well as farmers in the crop sector. No other agricultural commodity is forced to enroll in supply management in order to utilize risk management tools like crop insurance. But if the Dairy Security Act of 2011 introduced by Ranking Member Collin Peterson and Congressman Mike Simpson is passed by Congress, that's exactly what dairy farmers will be asked to do. The only safety net or risk management tool they will have access to will be the Dairy Producer Margin Protection Program triggered by a "national average" margin between milk price and feed cost.

If they sign up for that program, they are automatically enrolled in a Dairy Market Stabilization Program, which forces them to cut production when the margins trigger, even if they have not expanded.

National Milk Producers Federation favors this program because it is a one-size-fits-all approach. The grassroots dairy producers of the Dairy Policy Action Coalition (DPAC) oppose this approach, preferring individual margin protection tools such as LGM-Dairy.

Sustainability of dairy and livestock production is threatened today by the rapidly rising grain and forage prices and shortages that are occurring. This means dairy producers need to have “margin” tools they can use to manage their individual margins, not a national average margin that is tied to supply management.

DPAC favors individual margin protection through LGM-Dairy for several reasons. We can show how the “national margin protection” offered by the Dairy Security Act of 2011 would increase the federal government’s liabilities more than 25 times greater than the liabilities of a public/private partnership model like crop insurance (LGM-Dairy).

DPAC offers the suggestion of giving producers a choice between MILC and subsidized LGM-Dairy to meet the budget baselines for the dairy title. We have attached a power point by Bruce Babcock at Iowa State University, the creator of LGM-Dairy. This power point explains the costs of LGM-Dairy in the real world. The CBO score of \$5 billion is simply unrealistic. LGM-Dairy is a tool, not a blanket. Thus, not every drop of milk would ever be insured and even 50% is a high percentage. The CBO scoring has not looked at LGM-Dairy realistically.

One thing that gets lost in this discussion is the fact that large dairy farmers already have many tools available to them to manage their risk. Some experts have gone so far as to say they don’t need a safety net because they already have tools and options available to them commercially that the smaller farms and mid-sized farms do not have available to them.

Large dairy farms can contract out 3 to 5 years with processors, cooperatives, and marketing agencies in common. Large farms also often use “puts” and “calls” on the futures market to “effectively” protect a margin. Small to mid-sized farms cannot protect a margin this way because the contract sizes are too large, particularly on the feed side, which is where the margin pressure is currently coming from.

LGM-Dairy allows the small and mid-sized farm to be competitive and sustainable by providing a tool to “insure” a margin in much the same way as purchasing “puts” on milk and “calls” on feed in the futures markets.

Clearly, MILC serves a purpose in supporting smaller farms, who lack the size-and-scale advantages of the largest farms. By phasing out the MILC direct payment through a choice to use LGM-Dairy (much like the ACRE program for crops), small and mid-sized family dairy farms have the opportunity to manage their risk and remain competitive. This is important because having many 100-cow to 2000-cow dairies throughout the milksheds in this country sustain the local infrastructure of jobs and economic revenue to rural economies far better than consolidation to fewer farms concentrated in fewer regions.

Please see the attached report entitled “Further Analysis of Foundation for the Future’s Dairy Producer Margin Protection Program and Dairy Market Stabilization Program”

This report clearly shows the costly difference between the Peterson Draft’s Margin Protection Program and the public/private partnership of LGM-Dairy Insurance. The costly difference is obvious in federal liability and in the ability of the U.S. dairy industry to compete in the world marketplace.

This report is attached in this packet and is also available at http://www.dpac.net/publication_files/further-analysis-of-fftf.pdf

Hearing observation:

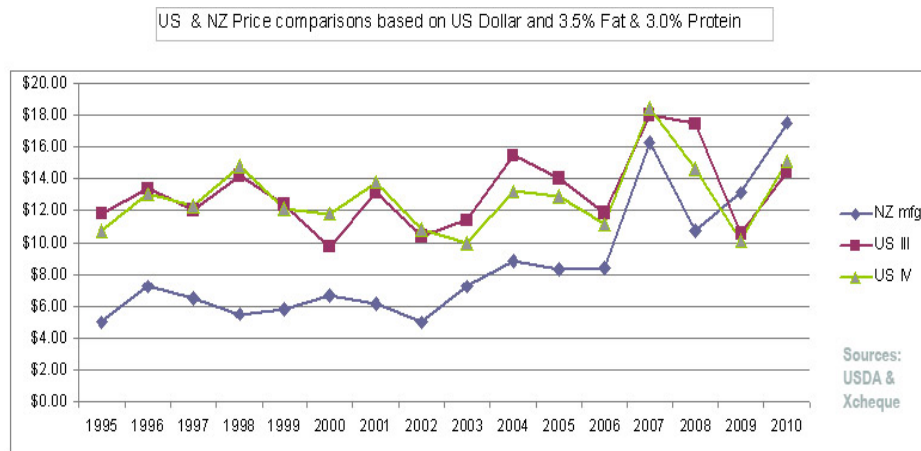
- II. Mr. Garcia talked about the dairy industry prices as a roller coaster with significant impacts, quickly, in 2009. He referenced the global market, stating that the global economic downturn, melamine scare in China, and increased value of the U.S. dollar, lowered demand for dairy products in the domestic and world markets, while grain prices kept feed costs relatively high.

DPAC Response:

Dairy consumption in 2009

According to the U.S. Dairy Export Council and other sources, world demand for dairy products actually grew 1.5% in 2009. The trouble is that the U.S. walked away from the market. Furthermore, domestic consumption of dairy products also grew in 2009. Even fluid milk consumption was up 1.2% over 2008 that year. We believe current dairy policy prolonged what should have been a swift, painful, but short-term drop in prices. Instead the U.S. price flat-lined and languished for 18 to 20 months when the world price recovered within 6 months.

The graph (below) shows a change has occurred in the world market since 2006 as evidenced by New Zealand milk prices vs. U.S. manufacturing milk prices (Class III and IV).



Volatility?

The problem in 2009 was not so much the fluctuation of prices, but essentially how long the price flat-lined at such a low level even though Oceania prices turned around.

The U.S. dairy industry essentially served as the “balancer” of the world’s supply of milk to the detriment of our own farmers because we did not compete and clear our products through the market. We sold to the government warehouse, while other countries moved their products to the global marketplace.



Under the DPPSP, the federal government purchased 276,156,841 pounds of nonfat dry milk (NFDN) in addition to butter purchases from Oct. 1, 2008 through Oct. 1, 2009.

Most of this powder was purchased from Oct. 1, 2008 through April 2009 when U.S. imports of milk protein concentrates (MPC’s) were at record levels in December 2008 through March 2009 before leveling off in June of 2009.

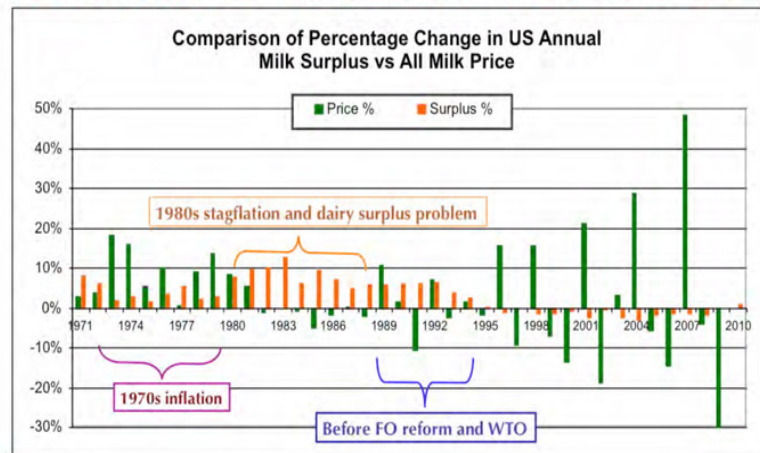
After New Zealand’s prices turned around in the summer of 2009, our government bought an additional 132,276 pounds of U.S. milk powder from Oct. 1, 2009 through Jan. 2010.

Global supply-and-demand is now a reality for U.S. dairy producers. In fact, Andrew Novakovic, Ph.D. – the E.V. Baker professor of agricultural economics at Cornell University and chair of USDA Secretary Tom Vilsack’s Dairy Industry Advisory Committee – makes some key observations in his August 2011 presentation “New Challenges, New Ideas: An overview of dairy issues and policies leading to the 2011/12/13?? Farm Bill.” The full report is available at: http://future.aae.wisc.edu/publications/policy_overview_novakovic.pdf

The graph (right) is from page 13 of Dr. Novakovic’s August 2011 paper as he discusses the various definitions and perspectives on volatility.

The final paragraph states: “Debating what is the best choice really has to begin with agreeing on what the problem is.”

Is Milk Price Volatility Caused by Excess Production or Fluctuations in Demand or?



Cornell University
Department of Applied Economics and Management

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From the graph above, the problem does not appear to be “surplus milk” since the U.S. has been running milk production deficits since the mid-1990s and yet charted the most significant percentage price drops at the same time. In his paper, Dr. Novakovic also makes these observations, which the dairy producers of DPAC believe hit to the core of identifying what the problem is:

- 1) “... domestic markets no longer have a sole or perhaps even primary effect on domestic prices.”
- 2) “An essential element of problem identification is simply using or having the data to describe and quantify a problem. This is easy to take for granted, but I would observe, after 35 years of doing policy and market analysis, that our access to current data has deteriorated considerably. We know a lot less about markets that are becoming increasingly complicated.” (emphasis added)

Since at least August of 2009, U.S. product prices and the raw milk prices, have lagged behind other nations, like New Zealand. A key reason is that we do not make – and market – products that foreign buyers (and in many cases domestic buyers) want.

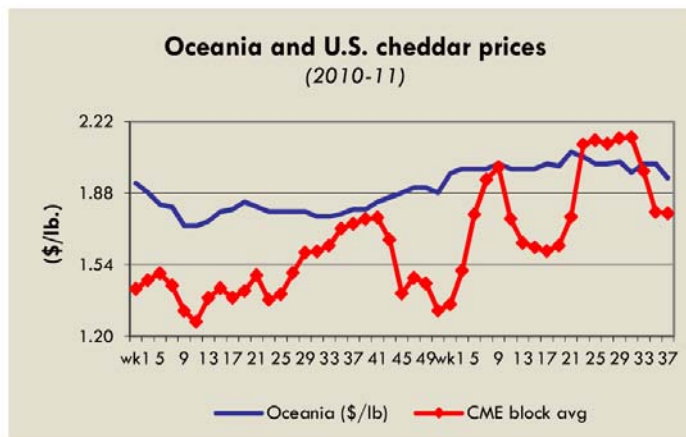
The DPPSP, along with the government-set “make allowances”, play a large role in holding back U.S. innovation and marketing because they create a low- or no-risk environment for the manufacture of brown-bag nonfat dry milk at specifications that meet the CCC standards, not necessarily the standards of world buyers.

As for cheese, our cooperatives – through the CWT program – collect producer assessments to pay for buyer discounts on the cheese products the cooperatives make in order to sell them overseas.

In 2010 and 2011, we saw record exports of proprietary dairy products moving “at the market.” Instead of using producer assessments to pay for buyer-discounts, the U.S. should be focusing on making the products our foreign customers want and developing customer relationships to participate in these growing markets to enhance producer returns.

This, again, comes back to federal dairy policies and programs and what these policies and programs “promote” in terms of business models in the dairy processing industry (both cooperative and proprietary plants).

Below is a graph published in the Sept. 15, 2011 edition of the CME Group Daily Dairy Report showing cheddar cheese prices in the Oceania region (New Zealand and Australia)—which represents a world price—versus the



cheddar cheese price on the Chicago Mercantile Exchange (CME)—which represents the U.S. price. The world price is far more stable than the U.S. price, in part because the U.S. dairy industry does not have a good process for discovering price and value. The next Farm Bill is a golden opportunity to move the dairy industry toward a more transparent market and better price discovery. This will only happen when policy makers follow the lead of many farmers who want a more competitive industry and a true market for their product.

Hearing Observation:

- III. Mr. Garcia stated that “stable markets are crucial to a healthy dairy industry. Commodity Credit Corporation (CCC) stands ready to buy certain dairy products at support levels under the Dairy Product Price Support Program. By doing so, the DPPSP helps support market prices. The acquired products are largely used to provide assistance to needy families both in the U.S. and overseas.”

DPAC’s Response:

On Sept. 8, 2011, USDA witnesses could not answer the question posed by Ranking Member Dennis Cardoza, who wanted to know what was purchased with the \$60 million Congress authorized for special cheese purchases in November of 2009 (what types of cheese) and how quickly that product was purchased off the commercial market and distributed to food banks.

It is DPAC’s understanding that shredded and chunk cheeses were purchased instead of bulk block cheese. Obviously, more cheese can be removed from the commercial market when bulk purchases are made; however, we do understand the cheese went directly to food banks and thus the shreds may have been more suitable for that purpose.

What DPAC does not understand is why USDA – in answer to a question posed by reporter Sherry Bunting five months after the cheese purchases began – stated that the bid solicitations were being spread out periodically over a year to “avoid market disruptions.”

Was that not the point of Congress giving the \$60 million for cheese purchases for food banks? Did they not seek to disrupt the market by removing cheese immediately in order to 1) help stabilize the disastrously low milk prices being paid to farmers? and 2) help get cheese into the hands of food banks that were under severe pressure to keep pace with food needs?

Hearing Observation:

- IV. Mr. Garcia also referenced The Foreign Agricultural Service (FAS) Dairy Export Incentive Program (DEIP), which provides a bonus on a bid-basis to exporters of dairy products to bridge the gap between world market prices and U.S. domestic prices. Since 2002, he said, the world dairy prices have warranted such USDA DEIP “bonuses” five times.

DPAC's Response:

Do export discounts paid by the government or by producers through assessments really make us more competitive globally?

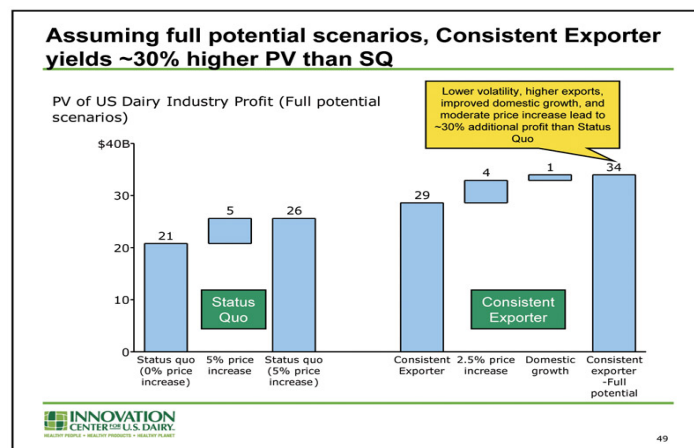
Export discounts do not serve the purpose of bridging a gap between world prices and U.S. prices any longer. These bonuses are another crutch that keep the U.S. from being a competitive force in the global markets.

The U.S. has five to seven years to establish the marketing relationships and produce the products the world wants. An August 8, 2011 report by Vernon Crowder, vice president and agricultural economist with the Food & Agribusiness Research Advisory Group in Fresno, California, details this opportunity and some of the problems the U.S. must overcome quickly. His report can be found at this link:

https://www.pressroomrabobank.com/publications/food_agri/rabobank_report_california_dairy_turn_west.html

The window of opportunity could close on the U.S. if the wrong policies are adopted in the next Farm Bill. "The Impact of Globalization on the U.S. Dairy Industry: Threats, Opportunities, and Implications" is a report funded by dairy farmers via the 10-cent per hundredweight milk check assessments for dairy promotion and research. The "Bain Report" can be found at this link:

http://www.dpac.net/publication_files/impact-of-globalization-on-us-dairybain2009.pdf



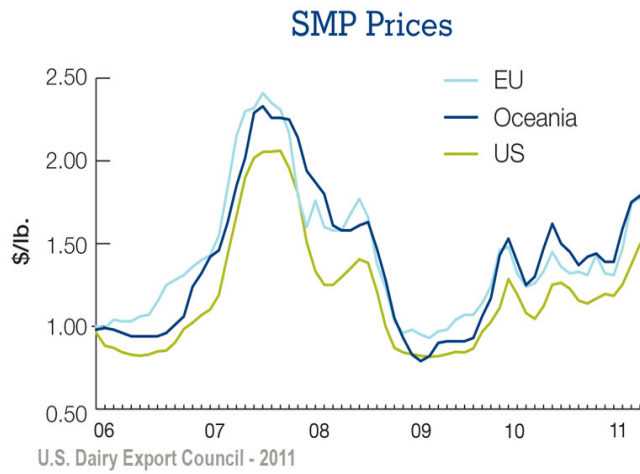
The "Bain Report" report analyzed global markets and found a "window of opportunity" for the U.S. to become a "consistent exporter" and provide for the unmet global dairy demand.

Skim milk powder (SMP) vs. Nonfat dry milk (NFD) is a good example:

Without a long term change in the current milk 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 will chip away at our industry, while we lose the export opportunities at the same time.

For example: World markets trade skim milk powder (SMP). The U.S. makes very little SMP compared with major manufacturing of nonfat dry milk (NFDM).

The difference is SMP has a standardized protein content (34%). NFDM is not as consistent in protein content, having a standard between 34 and 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 than SMP, which makes the per-point of protein value returned in the dairy farmers' milk check even lower.



US-produced NFDM also does not always meet the international customer's specification for quality, which is often higher than the USDA-CCC specification for government purchases under the current 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.

Hearing Observation:

- V. During the Sept. 8 hearing, House Ag Committee Ranking Member Collin Peterson asked USDA what it costs, and what are USDA's thoughts, in regard to "daily" electronic reporting. AMS Deputy Administrator Dana Coale talked about a cost of \$500,000 for the software development already underway to implement the Sept. 2010 legislation on "weekly" electronic reporting and \$500,000 a year as an estimate to administrate. As to what USDA "believes" in regard to making the reporting "daily" instead of "weekly," Ms. Coale cited in her response an industry comment from the current rulemaking process. She said the reporter noted "Daily reporting could in fact result in more misinformation being provided as the reporters would not be able to report accurate prices on a daily basis and would be submitting significant revisions to the numbers they submit."

DPAC's Response

Deputy Administrator Coale chose to answer the Ranking Member's question by focusing on only one out of the seven industry comments USDA had received on its proposed rule for which the comment period ended August 9, 2011. When Ranking Member Peterson asked who the "reporter" was making that official comment, Ms. Coale responded: "DairyAmerica."

DairyAmerica's full comment, as well as the comments of the grassroots Dairy Policy Action Coalition and five other entities can be found in the USDA rulemaking docket # AMS-DA-10-0089 at:

<http://www.regulations.gov/#!docketDetail;D=AMS-DA-10-0089>

Attorney Charles "Chip" English wrote the official comment submitted for DairyAmerica opposing daily reporting. Charles English is well known as the legal counsel for fluid milk processors Dean Foods, H.P. Hood and the PA Milk Dealers Association in Pennsylvania Milk Marketing Board (PMMB) meetings and hearings and in testimony at a June 2010 Pennsylvania State Senate hearing on the state's milk marketing law and mandated over-order premium.

This over-order premium – per PA state law – is paid by all consumers of fluid milk, and this premium is intended by law for the farmers. Current estimates by several entities, including the 2010 State Secretary of Agriculture, indicate that at least one-third of these premiums—paid by law by consumers and intended by law for the farmers—remain "in the middle" between the farmer and the consumer.

While at the same time the milk dealers and retailers are already, by law, guaranteed a separate calculation in the minimum retail price of fluid milk in Pennsylvania to cover their cost recovery plus a 2.5 to 3.5% profit on every gallon of fluid milk they sell in the state of Pennsylvania.

In fact, this phenomenon of premiums "stuck in the middle" occurs with voluntary market value, nationwide, as experts testified at the Department of Justice / USDA workshop in Madison, Wisconsin June 25, 2010 that the marketing channels have collapsed as processors and cooperatives have "coalesced" in order to "gain efficiencies" in relation to the consolidating retail sector.

However, the data reported by economists and attorneys at the DOJ / USDA joint workshop in 2010 point out that neither the consumers nor the farmers are truly benefiting from the efficiencies gained by this rapid consolidation of the marketing channels since 2000. The farmer's share of the consumer's total dairy dollar (for a market basket of products) was estimated at 26% in 2009 and 2010 compared with 42% as recently as 2004.

This Pennsylvania connection is significant to the national dairy policy discussion. Furthermore, it is interesting that the same attorney who represents the fluid milk bottlers on PA state milk marketing law issues (opposing milk marketing law changes that would ensure the state-mandated over order premium goes to the farmers) also wrote the official USDA rulemaking comment for DairyAmerica, which is located in California and is a federated marketing company, which warehouses and markets the milk powder (nonfat dry milk-NFDM) from multiple milk cooperatives who make the NFDM.

However, New Zealand-based Fonterra is actually the gateway to international marketing of DairyAmerica NFDM, receiving commission and buying low to sell high, as needed, to augment Fonterra's supply of milk powder produced in New Zealand and other countries.

If we look back to the misreported powder prices of 2006-07, we see that DairyAmerica was the main misreporter due to their inclusion of international sales through Fonterra, which were contracted more than six months in advance.

USDA estimates dairy producers lost an estimated \$50 million at that time, which was never refunded, due to the misreported powder prices during a nine-month period.

A report about the 2006-07 "misreported powder" incident is available at: http://www.dpac.net/publication_files/mis-reported-powder---lingering-questions-2007.pdf

Looking at the rules for mandatory reporting today, loopholes exist. For example, product that does not ship within 30 days of a negotiated price, does not get reported anywhere, at all. So, if reporting is weekly, and a company strikes a deal to sell 1000 lbs of powder at \$1.80/lb for delivery in 31 days and 1000 lbs of powder at \$1.40/lb for delivery next week, the only price that gets reported is the \$1.40/lb, and that is what is entered for the week to be weighted for the month and used in the end product price formula to establish raw milk prices. Yet, the "market" could be said to be \$1.60 as the net between the two transactions.

Daily reporting forces more accountability and transparency into this system of reporting cheese, butter, whey and NFDM transactions, particularly sales volumes. Perhaps a future price should be listed on the day it is set into the future as that is a market indicator.

The reporting issues do not stop with frequency. More products should be reported, as explained in DPAC's official comment to USDA on the proposed electronic reporting rule (Docket AMS-DA-10-0089), which is attached and also can be found at the regulations.gov website: <http://www.regulations.gov/#!docketDetail;D=AMS-DA-10-0089>.

With the technology available in the 21st Century, it appears murky to most dairy farmers to see their milk price indirectly based on the Chicago Mercantile Exchange “spot” market, where less than 1% of the cheese and less than 2% of the butter is actually traded.

Congress authorized “more frequent” reporting in Section 1510 of the 2008 Farm Bill. The industry has had weekly reporting for years.

The September Mandatory Reporting Act implements the electronic reporting method, but the reporting is still weekly, which is no more frequent than before.

Access to current data is critical in today’s ever-more-complex dairy markets.

Hearing Observation:

- VI. Deputy Administrator Coale also noted that, “The concerns we have been hearing on daily reporting are ones the industry has expressed in relation to how accurate the price information will be. Is that data really accurate and does that provide the information that (farmers) need to make marketing decisions?” She further stated that, “It’s important to note that the dairy industry operates differently than other commodities within agriculture, in that producers are paid based on a federal monthly price. So receiving a daily report of what commodities are trading at does not translate directly into a pay price for those producers.”

DPAC’s Response:

As dairy farmers, we beg to differ. While it is true that under the current Federal Orders (which dairy farmers pay to operate via marketing service deductions the administrators take from their milk checks) the price of milk is based on monthly weighted average prices of products, yield factors and make allowances entered into Federal Order formulas to arrive at classified manufacturing milk prices...

Processors and cooperatives contact producers about forward contracting opportunities, mainly using futures-based tools offered by the cooperatives. Knowing the daily trading value of dairy products would be helpful in making business decisions to utilize various risk management tools.

DPAC believes all sectors of the dairy industry – including the farmers – should have access to a transparent market and to be equally informed on market conditions.

Improve Market Transparency & Price Discovery

Today's milk pricing system is a bit like the "wizard behind the curtain"... pulling this lever and that lever to keep the people of "Oz" from seeing what's really on the other side: What is the true value of our product in the marketplace? And how is the value of so many dairy products being passed back through the system to the farm?

Dairy farmers are united on this one major point: Pull away the curtain and introduce price discovery that is simple and transparent so we can be fully informed participants in the market for our products.

We have little say in how our prices are fixed by the federal orders. When mistakes are made, we have no redress. (See **Farmshine reprint June 4, 2007 at http://www.dpac.net/publication_files/mis-reported-powder---lingering-questions-2007.pdf**).

For example: The misreported powder prices in 2006-07 cost dairy farmers a minimum of \$50 million. Another example is the current "make allowances" and "yield factors" in the product price formulas. The product price formulas that are used now to set our milk price helped transfer wealth from producers to processors just as we hit the world economic collapse.

The farmer's share of the consumer's dairy dollar (for all dairy products) has declined from 42% as recently as 2002 down to 27% in 2009-10, according to experts who testified at the USDA / DOJ workshop in Madison, Wisconsin in June 2010.

Meanwhile, milk has gone from a small margin product to a literal "cash cow" for the ever-larger supermarket chains that dominate the price squeeze back through the supply chain.

Thank you for your consideration of our comments

The Dairy Policy Action Coalition, September 27, 2011