



BEFORE THE UNITED STATES DEPARTMENT
OF AGRICULTURE
AGRICULTURE MARKETING SERVICE

In the Matter of Milk in California
Notice of Hearing on a Proposal to
Establish a Federal Milk Marketing
Order

7 CFR Part 1051
Docket No.: AO-15-0071
AMS-DA-14-0095

Clovis, California, October 2015

Testimony of Dr. William Schiek
Part 2

Introduction

Pool plant definitions, supply plant definitions and shipping requirements, diversion limits, and producer milk definitions (touch base requirements and repooling restrictions) are elements essential to a Federal Milk Marketing Order (“FMMO”) for the purpose of assuring that milk which associates with the pool will be made available for Class I uses. Under Proposal 2, the proposed language in Sections 1051.7 (a) and (b) define which plants will be pool distributing plants under the FMMO. Section 1051.7 (c) defines the requirements for supply plants and the qualifying shipments they must make. Definitions for producer milk, with diversion limits and repooling restrictions, are contained in Section 1051.13.

Pooling Standards are Necessary Incentives to Direct Milk to Class I Uses

There are two key aspects of the way these provisions direct milk to Class I uses. First, the higher value of Class I milk is available to be shared among producers through the pool because plants with Class I usage above a specified percentage are included as pool distributing plants. The availability of these Class I revenues creates an economic incentive to associate dairy farmers’ milk with the pool. Once the milk associates with the pool, the required supply plant shipping percentages and producer milk definitions, collectively referred to by me as pooling standards, serve to direct pool milk to Class I uses. Higher Class I revenues serve as the “carrot” to attract milk to participate in the pool, while the pooling standards are the “stick” that establishes the conditions by which handlers can continue to pool dairy farmers’ milk and enjoy the benefits of pooling. The working of the two forces, “carrot” and “stick,” is central to how the orders ensure that milk supplies will be adequate for fluid milk purposes and that the milk

actually moves to Class I uses. Class I plants, in exchange for paying higher regulated prices than plants producing products in other classes the vast majority of the time, have the benefit of regulation designed to direct milk to their plants.

I am not aware of any other regulatory provisions that effectively attract milk to the pool and ensure that it be made available for Class I purposes. In the proposed rule stemming from a Central order milk pooling hearing, the Secretary found (71 Fed. Reg. at 54152⁵⁴¹⁵² (2006))^{Sept. 13,}:

“The pooling standards of all Federal milk marketing orders, including the Central order, are intended to ensure that an adequate supply of milk is available to meet the Class I needs of the market and provide the criteria for determining the producer milk that has demonstrated service in meeting the Class I needs of the market and thereby receive the order’s blend price. The pooling standards of the Central order are represented in the *Pool Plant, Producer* and the *Producer milk* provisions of the order and are based on performance, specifying standards that if met, qualify a producer, the milk of a producer, or a plant to share in the benefits arising from the classified pricing of milk.

Pooling standards that are performance-based provide the only viable method for determining those producers eligible to share in the marketwide pool. It is usually the additional revenue generated from the higher-valued Class I use of milk that adds additional income to producers, and it is reasonable to expect that only those producers who consistently bear the costs of supplying the market’s fluid needs should share in the returns arising from the higher-valued Class I sales. An important objective of pooling standards is identifying the milk that serves the fluid milk needs

of the market, a feature which if ineffective can result in pooling milk that is not providing such service.”

Relying Solely on Market-Based Class I Premiums to Direct Milk Burdens Class I Plants.

There has been some discussion at this hearing in testimony supporting Proposal 1 that seemed ^{to} suggest that over-order Class I premiums were sufficient mechanisms for directing milk to Class I uses. While over-order premiums might be able to assist in moving milk to Class I plants, they are not regulatory instruments that are under control of USDA. The assumption that Class I plants will always pay the premiums necessary to attract a milk supply ignores the fact that they are already paying higher prices through Class I minimum prices via Class I price differentials.

The combination of the already higher regulated prices for Class I milk and the need to pay additional over-order premiums because order provisions provide insufficient incentives to direct milk to Class I plants could also result in fluid milk prices to consumers that are higher than needed. In other words, if effective pooling standards are not in place, the effective Class I raw product cost would be higher than it would be under an order that had them. Higher raw product costs to Class I plants would likely lead to higher prices to consumers, particularly if all or the majority of competing Class I handlers in the market are experiencing increased raw product costs because they must pay additional premiums, which would likely be the case.

If reliance on Class I premium dollars is the primary means to attract milk to the Class I market, it raises the question as to the purpose of Class I price differentials in the market. If we are not going to use the combination of higher regulated Class I prices and effective pooling

standards to attract and move milk to Class I uses, then why do we need Class I differentials at all?

In his testimony at this hearing (Hearing Exhibit 70, page 31), Mr. Dennis Schad stated that the \$1.60 per hundredweight minimum Class I differential (base differential) is built up from three components. The first component, valued at \$0.40 per hundredweight, is what some refer to as the Grade A differential, which represents the cost to a producer to maintain his Grade A status. In 2015, I have to question the viability and relevance of this argument when just over 1% of California milk is Grade B. The second component in the base differential, according to Mr. Schad's testimony, is valued at \$0.60 per hundredweight and meant to capture the marketing costs associated with Class I milk, which "...include such things as seasonal and daily reserve balancing of milk supplies, transportation to more distant processing plants, shrinkage, administrative costs, and opportunity or "give up" charges at manufacturing plants that service the Class I markets." The third component of the base differential, also valued at \$0.60 per hundredweight, is described by Mr. Schad as representing a portion of the competitive premium required to compete with processors of manufactured milk^{products}. Mr. Schad noted further that the value of the transportation credits under Proposal 1 would support an additional differential of \$0.60 per hundredweight at a market Class I utilization of 15%, or an additional \$0.72 per hundredweight at a market Class I utilization of 12.5%.

Embedded in this discussion of what the appropriate level of the Class I differential should be is the amount of money necessary to serve the Class I market and direct milk to Class I uses. Under order provisions that have ineffective pooling standards, and that rely on over-order premiums to direct milk to Class I uses, Class I processors have to pay a second time for items that were supposed to have been already paid for through the Class I differentials.

Dairy Institute's Proposal, Proposal 2, provides for pool plant definitions, supply plant shipping requirements, diversion limits, producer touch-base requirements, and repooling restrictions. The specifics of the provisions that we proposed will be/~~has been~~ set forth in testimony from other Dairy Institute witnesses. However, we do view these provisions as an essential part of maintaining the orderly movement of milk for Class I purposes. By limiting the privilege of pooling to those that serve the Class I market, the operation of pooling standards provides a necessary incentive for producers and handlers to supply the Class I market.

Mandatory Pooling Removes Incentives in Regulation that Direct Milk to Class I Uses

If Class I revenues can be accessed without meeting specific performance requirements, which would appear to be the case under the cooperatives' mandatory pooling requirement contained in Section 1051.7 (c) of Proposal 1, a crucial incentive to supply the Class I market is missing. There does not appear to be a compelling reason to supply milk for Class I uses under Proposal 1 because there is no penalty for failing to do so. That is, if a handler operating a manufacturing plant in California is able to pool its milk and have its producers share in the higher Class I revenues in the market without actually being required to supply the Class I market, it does not have an incentive to make qualifying shipments.

The lure of being able to access Class I revenues encourages plants to pool and to perform (supply the Class I market). If a handler retains its ability to access Class I revenues for its producers, even when it fails to perform, then it has a viable, penalty-free option in not performing, and the pooling regulations as proposed will be ineffective at directing adequate

milk supplies to Class I uses. This is a fundamental problem with mandatory or “inclusive” pooling.

Transportation Credits Do Not Substitute for Performance Requirements

There has been testimony at this hearing that seems to suggest transportation credits will ensure that the Class I market will be served. The description of transportation credits under Proposal 1 appears to make a compensation for added transportation costs associated with bulk milk shipments to plants in deficit areas with Class I and Class II usage of greater than 50%.

My understanding is that these transportation credits would make producers, at best, indifferent between shipping to a qualifying plant in a deficit area or shipping to a local manufacturing plant, and in many cases there would still be a shortfall in the cost of shipping the milk when compared to the cost of the local haul. No doubt there is some close-in milk, where the best alternative is to ship from the farm to a qualifying deficit plant. But close-in milk, produced within or near to deficit regions, has been declining in recent years. Milk will need to move to deficit markets, but Proposal 1’s pooling standards do not appear to provide the necessary incentives for dairy farmers and their cooperatives to supply the fluid market. A positive incentive to move milk to Class I uses could be constructed by using transportation credits to provide money for producers that goes beyond the actual costs of transporting milk from surplus to deficit areas. However, such a strategy would likely lead to uneconomic milk movements. More milk than is needed would likely move to deficit markets to take advantage of the over-generous credits.

Mandatory Pooling Interferes with the Ability of the Market to Clear

If Class III and IV prices are set above market-clearing levels, manufacturers have no incentive to procure surplus milk. It must then be sent to out of state plants, burdening the transportation system and interfering with the normal orderly marketing of milk for fluid use.

Under mandatory pooling, if Class III and IV prices are above prices at which California dairy product manufacturing plants can profitably operate, there is no escape valve that allows for plants to pay less than the regulated price (under class), even if such milk would be available for purchase at prices that these plants could afford. The result of setting regulated milk prices at levels that are above the plants' ability to pay is that some of these plants will exit the industry, plant capacity in the state will shrink, and there is a possibility that excess milk will be looking for alternative homes either nearby if they are available, or at a more distant location if no nearby location is available. Under such a scenario where milk is chasing plants, uneconomic movements of milk are likely. Dairy farm incomes could become depressed because of the loss of homes for their milk and the marketing losses associated with moving the milk longer distances.

Automatic Pooling on the California Order of a Nevada Manufacturing Plant is not Justified.

Given the low Class I utilization in the California market, there does not appear to be any policy justification for automatically granting pool status to a Nevada dairy product manufacturing plant, as proposed by the cooperatives. Milk from such plants is not needed as a reserve supply for California's fluid milk plants because adequate supplies of milk for Class I use are available within the state. The association of Nevada producers with the California market was based on

historical institutional relationships and a lack of local alternative outlets for the milk. With the opening of the new manufacturing plant in Churchill County, some of those market outlet concerns have now been alleviated. Under Proposal 2, a Nevada manufacturing plant would not be barred from associating with the California pool if it performs by making qualifying shipments to fluid plants and conforms to the other pooling standards.

Summary

Our view is that pooling standards play a central role in assuring consumers an adequate supply of wholesome milk for beverage purposes. The attraction of milk to the pool and the need to perform in accordance with the pooling standards are important mechanisms for assuring that Class I plants and, ultimately, consumers get the benefits of milk price regulation under the orders. Effective pooling standards justify the higher Class I regulated prices under the orders by making use of that money to direct milk to fluid plants. Mandatory pooling, as proposed by the cooperatives, undermines the efficacy of pooling standards by allowing producers and handlers the benefits of pooling, without imposing the important performance requirements that help ensure the Class I market is served.

A filing made on behalf of a group of cooperatives, which included two of the three proponents of Proposal 1, in relation to a federal order hearing on pooling issues in the Mideast order contained the following statement about pooling provisions: “These cooperatives wish to further commend the Department for the straightforward findings and rationale of this interim decision which makes clear that the pooling provisions of federal milk orders must be related to performance for, and in service of, the Class I market, which is a central purpose of the

marketing orders.” I did not attend that hearing and am not familiar with all the issues that were considered as a part of that proceeding. Nonetheless, the notion that pooling provisions “must be related to performance for, and in the service of, the Class I market” is one with which Dairy Institute agrees.