

**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 Sue M. Taylor
on behalf of Leprino Foods Company
Part 1**

I am Sue Taylor, Vice President of Dairy Economics and Policy for Leprino Foods Company ("Leprino"), headquartered in Denver, Colorado. Our business address is 1830 West 38th Avenue, Denver, Colorado 80211. Leprino operates nine plants in the United States, manufacturing mozzarella cheese and whey products domestically and marketing our products both domestically and internationally. Three of the nine plants are located in the state of California and will be directly impacted by the outcome of this hearing if a Federal Milk Marketing Order (FMMO) is subsequently adopted through a producer referendum. Therefore, Leprino has a strong interest in the decision by USDA as a result of this hearing.

Expertise

In my role as Vice President of Dairy Economics and Policy at Leprino Foods, I am responsible for developing the company's economic policy positions and advocating those positions in appropriate forums, such as today's hearing. I have represented the company at all FMMO and California Stabilization and Marketing Plan hearings that have related to cheese milk pricing over the last twenty years.

My professional responsibilities have focused on dairy economics and policy issues since 1989, when I joined Sorrento Cheese as a production analyst and developed the dairy economist role. From 1992 through 1994, I was a principal in a dairy economics and management consulting business, Dairy Management Concepts, which provided consulting services to a broad spectrum of dairy companies, most of whom operated processing or manufacturing plants. I have been at Leprino since January 1995, leading the dairy economics, policy and milk procurement efforts for roughly twenty years before transitioning the milk procurement responsibilities to our broader procurement group over the last year.

My educational background includes both bachelor's and master's degrees from Cornell University in agricultural education with heavy emphasis on agricultural economics. Immediately after my Bachelor degree, I taught High School Agriculture. Immediately after my master's degree, I worked as an agricultural loan officer within the Farm Credit System, managing a portfolio of dairy farm loans and mortgages on behalf of Production Credit and Federal Land Bank.

Position

Leprino supports the adoption of proposal number 2, developed by Dairy Institute of California, if USDA promulgates a FMMO that includes California. I will be testifying later in the hearing on issues specifically related to the Class III formula and other aspects of the Dairy Institute proposal.

My testimony today will focus upon Leprino's opposition to mandatory regulated minimum price application to all milk manufactured from grade A milk within a geographic market. Specifically, I am speaking in opposition to the pool plant definition found in §1050.7¹(c) of the cooperative proposal (Proposal 1). This section defines a *"plant that is located in the marketing area which during the month receives milk from a producer located in the marketing area or from a cooperative marketing the milk of a producer located in the marketing area pursuant to §*

1050.9(c)" as a pool plant under the Order. Although the effect of this provision has been referred to as "mandatory pooling" or "inclusive pooling", I think of it as mandatory pricing since pricing and pooling are separate activities and it is the market effects of mandatory participation in minimum regulated pricing for all milk within a geography that is at the root of my concern.

Although the California State Order has applied minimum regulated pricing to all grade A milk produced and processed in the state for decades, it has not been without negative market impacts. The risks of setting the minimum regulated milk price too high in a system of binding minimum prices are significantly amplified. These include, amongst other things, threats to the financial viability of manufacturers and the plant capacity they provide and inefficient movement of milk in order to clear the market to out-of-area entities that are not subject to binding minimum regulated prices. This inefficient movement of milk in order to clear surpluses also results in lower producer returns due to increased cost to transport. I and others will speak in greater detail on these issues in later testimony supporting the class prices provisions of Proposal 2.

Another less obvious negative market consequence of mandatory pricing and pooling is the reduction of competition across manufactured product classes. In the context of a largely manufacturing milksheds with low Class I utilization and value under a normally constructed FMMO, marginal milk would tend to be bid into the higher valued manufacturing complex. This happens today in areas without binding regulation, such as Idaho. The competition for milk between cheese and dry milk plants in Idaho results in the bidding away of marginal milk from the lower valued use when there is a large price disparity. The resulting increased production of the higher valued use product has a dampening effect on the product prices in that complex. The reduction in production within the plants with the lower valued use reduces the product surplus and contributes to a firming of finished product prices in that complex.

However, in a regulatory scenario in which grade A milk cannot exist outside the regulated pricing system and in which the margins are neutralized across manufacturing complexes by end-product price formulas specific to the respective complexes, there is little incentive to move milk to the higher valued complex. I believe that the California State Order adoption of split prices for the manufacturing classes of Class 4a and 4b in 1989 within the confines of mandatory pricing and pooling contributed to the divergence of values and increased volatility for the cheese and butter / dry milk complexes thereafter. The divergence of product value later resulted in USDA adopting split manufactured classes, first through the Class III-A mechanism in the early 90s and later with the establishment of Class IV in Federal Order Reform.

Figure 1 (attached) shows the gross product values on a milk equivalent basis using the yield factors that exist in the current FMMO Class III and IV formulas for the two complexes. Figure 2 (attached) shows the difference as defined by subtracting the gross Class IV value from the gross Class III value. Make allowances are omitted from the analysis for simplicity. Prior to California's establishment of separate milk prices for the cheese complex and the butter / dry milk complex in the late 1980s, marginal volumes of milk more easily moved to the complex yielding the higher returns. In so doing, the reduced production of the lower valued complex resulted in an increase in prices for its products while the increased production of the higher valued complex resulted in a decrease in prices for its products, driving toward price convergence across the uses. Wholesale shifts of milk between the complexes were not required to effectuate the convergence; uncommitted milk moving on the margins was sufficient. The disparate values across the two complexes that developed after California split the manufacturing class pricing eventually led to pressure to similarly split the manufacturing complex in the FMMOs.

Within the regulated milk supply which includes all grade A milk under the existing California Order and under proposal 1, market signals that ordinarily would compel a manufacturer to adjust output (increasing production when higher prices signal shortages and

decreasing production when lower prices signal surpluses) are negated by the parallel movement of costs with finished product values. The lack of a margin-driven incentive to adjust production volumes results in a slower adjustment to market surpluses and deficits of specific finished products. This lack of timely adjustment contributes to higher price volatility for those finished products. The result is that milk from lower valued uses whose margins are protected by the same system remains more competitive than the market would otherwise dictate. In essence, road blocks exist that dissuade milk from moving to its “highest and best” manufactured use.

The ultimate consequence is that one class of manufactured products may be in shortage at the same time that another class of manufactured products may be in surplus. That inability to attract milk from lower valued manufacturing uses to higher valued manufacturing uses results in prices of manufactured products pushing to greater extremes (both on the high and low side). These prices are sustained for a longer period of time than would be the case if differentials in the economic value of those manufactured products allowed markets to move milk. This volatility hurts producers, processors and consumers. And the sustained disconnects are troublesome both at the producer and processor levels. The different price levels create very different returns for producers across regions in the country, depending upon investment in Class III and IV capacity in the region and create challenges for processors, particularly in the export markets.

Although I am critical of the market impacts of the split manufacturing classes that exist in both the California and existing FMMOs, I am not advocating a change in that structure at this time. But it is very important that, if USDA promulgates a California Federal Milk Marketing Order as the result of this proceeding, mandatory minimum pricing of milk for manufacturing not be adopted. Adopting the same discretion regarding the regulated price application to milk for manufacturing that exists in all other FMMOs will allow the marketplace to work across greater volumes of milk and, I believe, will result in the greater movement of milk into the higher valued product complex at any given time. That increased responsiveness to market forces on 20% of

the US milk supply (and a volume roughly equivalent to New Zealand's total milk production) will benefit the entire US industry, including producers, processors, and consumers.

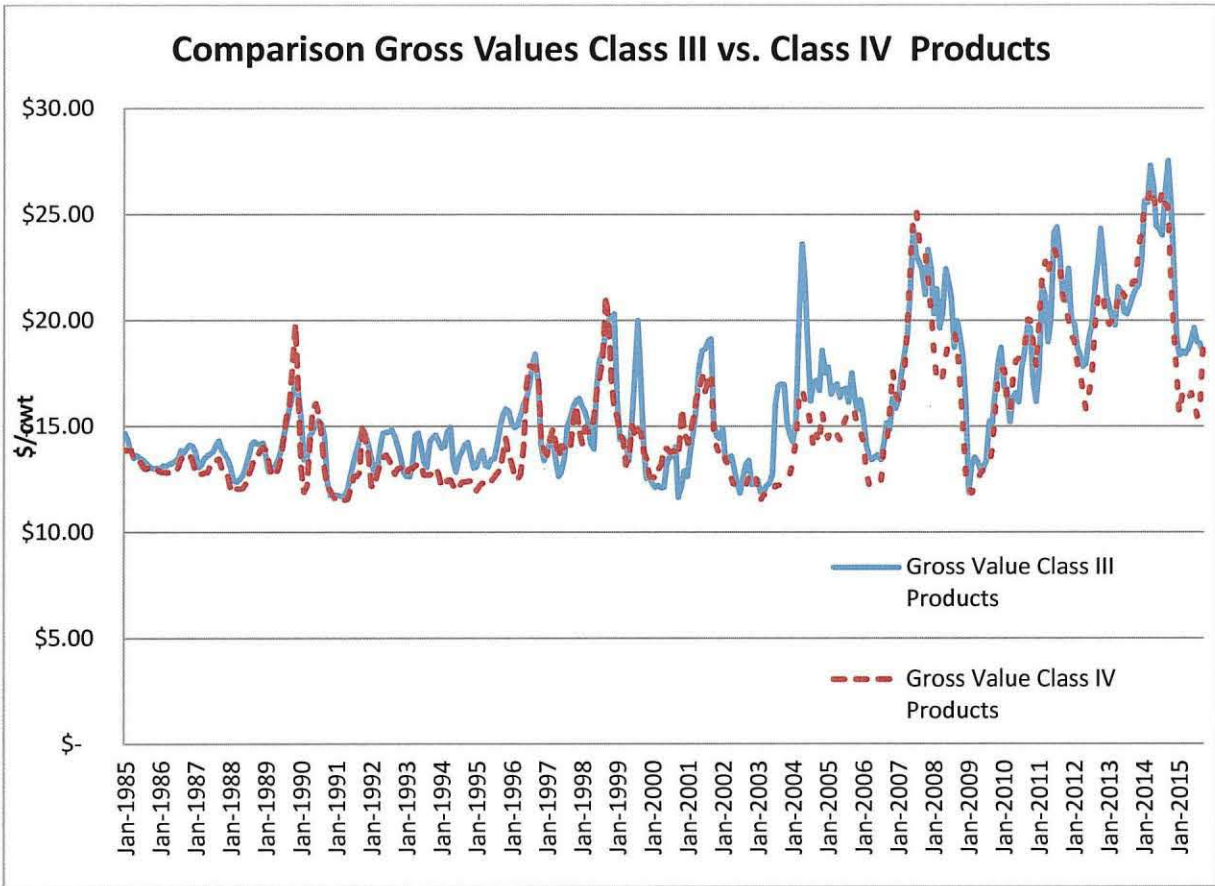


Figure 1: Comparison of gross values between Class III and Class IV products.

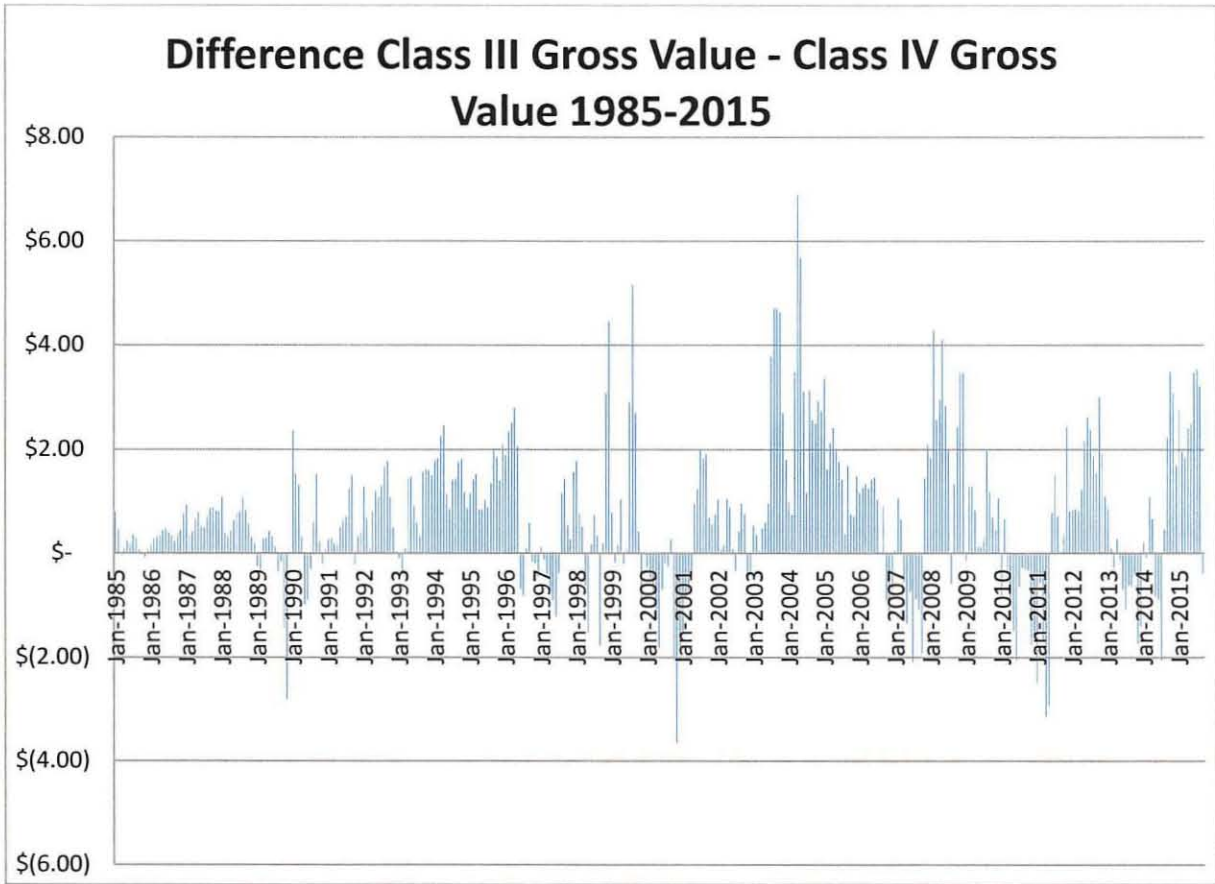


Figure 2: Difference in Gross Value - - Class III less Class IV gross value.