Direct Testimony for Federal Milk Marketing Order Pricing Hearing
American Farm Bureau Federation
Category 5: Class I and Class II Differentials
Proposal 21: Update Class II Differential

Pre-submitted September 16, 2023

The American Farm Bureau Federation (AFBF) has nearly 6 million members in all 50 states and Puerto Rico, including many thousands of cooperative and independent dairy farmers. Most of these dairy farmers are directly affected by the pricing provisions of the Federal Milk Marketing Orders (FMMOs).

These dairy farmers play a crucial role in the development of AFBF dairy policy. Every Farm Bureau position and proposal is based explicitly on that policy, developed through a grassroots process in which farmers make the decisions every step of the way.

AFBF submitted 9 proposals for consideration in this hearing and appreciates the opportunity to address the four that were accepted by USDA, as well as the clear direction on what may be needed to advance the rest.

A fundamental focus of AFBF's proposals is the reduction or elimination of negative producer price differentials and the de-pooling they cause. We believe that an orderly pool is the key to orderly marketing and ensuring Federal Milk Marketing Orders continue to benefit farmers, cooperatives, processors, and consumers. The key to an orderly pool, in turn, is, above all, the proper alignment of the four Class prices.

This statement covers AFBF Proposal 21 under Category 5, Class I and Class II Differentials.

Proposal 21. The American Farm Bureau Federation proposes to update the Class II differential based on current drying costs.

The Class II differential was developed during order reform to reflect the cost of drying and rewetting milk, to reflect the higher value of Class II milk without incenting processors to dry and rewet (Class IV) milk for Class II uses. **AFBF accepts this logic and proposes to update the Class II differential to $1.56.**

This cost-based element of the Class II price formula is out of date, and no longer meets the purpose of incenting the availability of Class II milk, per USDA's logic at the time of order reform.

Some processors argue that powder is not rewetted for most uses, so that the (minimal) cost of rewetting is not an appropriate consideration for this calculation. For that reason, to be conservative and for simplification, we propose to incorporate only the cost of drying in setting the Class II differential. Ideally, this would be based on a recent mandatory and audited cost and yield survey; in the interim, however, this could be updated using the current make allowance for nonfat dry milk (ndm), together with the current nonfat solids yield factor and updated butterfat and nonfat solids tests for milk in the FMMOs.

The cost of drying skim milk can be calculated then as:

$0.1678 x 0.99 x 9.4121 = $1.56

or

NDM make allowance x lbs. NDM/lb. NFS x avg. lbs. NFS/cwt. skim milk = cost of drying

The 9.4121 factor is based on the 2022 average nonfat solids test in the FMMOs (9.03%), divided by the average skim milk test (100% - 4.06%). This relies on a butterfat test for all markets and a nonfat solids test for component markets; using the butterfat test for only component markets would raise the differential calculation, since the skim/butterfat markets have the lowest butterfat tests; so, this calculation is conservative.

The original 70-cent Class II differential was nominally based on the cost of drying condensed milk and rewetting it, presumably because dried and reconstituted Class IV milk substituted for Class II skim condensed milk first, and the differential should not be higher than the cost to convert that relatively standard Class II ingredient form into a Class IV form. Based on the last mandatory audited survey of nonfat dry milk manufacturing costs, by the California Department of Food and Agriculture, the energy costs of drying skim milk were about 3.5 cents per pound in 2016; given that the energy costs of manufacturing butter were about 1 cent per pound, we will assume that 2.5 cents of the ndm costs are direct energy costs of the drying process. Skim condensed milk contains about 3 times the skim solids as skim milk; so, producing a pound of ndm from skim condensed milk may require roughly a third of the direct energy. This suggests that the cost of producing a pound of ndm from skim condensed milk may be roughly 0.8 cents per pound lower than a make allowance calculated for drying skim milk, which would yield a Class II differential of $1.49 per hundredweight. (64 FR 16103, et seq.)

However, we believe that the simple update, using the presumed cost of nonfat dry milk processing, achieves the original purpose of the Class II differential without incenting uneconomic drying of Class IV milk for price differences alone. There is no logical reason not to include condensing costs when assessing the cost of using Class IV milk for Class II uses through drying and even the simple addition of powder to a processing vat. Condensing costs would be faced by a Class II processor acquiring milk and using it directly, or condensing it as part of a process of drying it and using it to pay the Class IV price.

Much of Class II use was once part of Class I, based on the idea that it faced similar balancing challenges as Class I. The substantial innovation when Class II was created was to separate it from the location element of the Class I differential. However, there is a reasonable justification for a Class II differential as high as the minimum Class I differential, which is now $1.60/cwt. and is proposed by NMPF to rise to $2.20/cwt. In effect, based on the historical logic of the Class II differential, we would argue that the Class II differential should be the lower of the minimum Class I differential and the cost of drying per hundredweight.

The impact of the proposed change to $1.56 will be to increase the minimum order value of Class II milk by 86 cents per hundredweight, increasing the average pool value in every market and reducing the likelihood of negative PPDs and attendant de-pooling. There were 14.2 billion pounds of Class II milk pooled in 2022; so that in a static analysis, the value of pooled milk would be increased by $122 million. The $1.56 differential is lower than the lowest Class I differential ($1.60), so, combined with a return to the "higher-of" Class I price formula, maintains Class I prices above Class II in every month. (We support

proposal 19, in principle. This proposal would significantly raise Class I differentials, further ensuring that the Class I price should be consistently above the Class II price at any location.)

(See *Milk Component Tests by Order, Annual Summary 2022*, USDA, Agricultural Marketing Service, linked to at https://www.ams.usda.gov/resources/marketing-order-statistics/producer-milk-components-order;

California Manufacturing Cost Annual, 2016 Data, California Department of Food and Agriculture, see: https://www.cdfa.ca.gov/dairy/pdf/Annual/2017/ManufacturingCostAnnual2016Data.pdf)

Language (including the elimination of advance pricing):

1000.50

…

(e) Class II skim milk price. The Class II skim milk price per hundredweight shall be the ~~advanced~~ Class IV skim milk price computed in paragraph (q)(2) of this section plus ~~70 cents~~$1.56.

…

(g) Class II butterfat price. The Class II butterfat price per pound shall be the butterfat price plus $0.~~007~~0156.

This change to the Class II differential should be made whether or not advanced pricing is eliminated for Class II skim milk, although the changes are mutually reinforcing, if undertaken together.

Although AFBF opposes any increase in manufacturers' make allowances under the current conditions, we further propose here that if such increases to the nonfat dry milk manufacturing allowance (or adjustments to product yield and milk composition) are made through this proceeding, that a corresponding increase in the Class II differential be made as well. In addition, if automatic updates to the make allowance for nonfat dry milk are implemented through this proceeding, the Class II differential should be updated in lockstep, with language referencing the make allowance and yield, however they may be incorporated into the Class IV milk and nonfat solids formula language. In addition, any one-time or regular updates to the component value of the Class IV milk price formula should be used to adjust the component test factor in the equation above.