Introduction/Expertise

My name is Chris Herlache and I am here to represent Schreiber Foods, where I currently hold the title of Commodity Risk Strategies Manager. Schreiber Foods is a customer-brand leader in the production and sales of cream cheese, natural cheese, process cheese, beverages and yogurt. Our more than 10,000 employees and presence on five continents enable us to be an essential ingredient in our customers' success. With annual sales of more than $7 billion, we partner with the best retailers, restaurants, distributors and food manufacturers around the globe.

My background in dairy started with the dairy farm I grew up on in Northeast Wisconsin. From there I attended the University of Wisconsin where I got my undergraduate degree in Agriculture and Applied Economics where I had several projects and papers related to federal order reform, which was happening at that time. After graduating, I started at Schreiber Foods in the summer of 2000 in their finance department, and in 2003 I took a position in Risk Management. Since then, I have led the development of our internal Risk Management capabilities and customer forward contracting services and have helped to develop risk management programs for some of the world's largest food service and retail companies. In addition, I have responsibilities at Schreiber Foods related to dairy market policy and was the chair of the Class III/IV subcommittee of the IDFA economic policy committee. I have been a speaker at numerous conferences on the topics of dairy economics, risk management, and dairy policy, and have assisted in the education and development of dairy futures markets in the U.S. and Europe.

Position

This testimony is in support of proposals 14 or 15 to amend the base Class I Skim Milk Price to be equal to the average of the Advanced Class III and Class IV Skim Milk Price plus a rolling adjustment. In addition, this testimony is in opposition of Proposal 13, Proposal 17, and Proposal 18 that seek to reinstate using the "higher of" the Advanced Class III or Class IV skim milk prices in setting the Class I skim milk price.

Background

There have already been several references in this hearing to the importance of risk management to the industry. Today I want to provide additional testimony to the importance of risk management for Class I milk, and how the concerns of both Farmers and Processors can be met, which unfortunately feels like a rare, but ideal outcome when it comes to milk pricing policy.

In my experience over the past 20 years, risk management has developed into a necessary tool for companies with exposure to volatility in dairy markets. However, that has taken time to develop. When dairy markets were still new in the early 2000's, there was a lot of education that my team and I did with our customers to help them understand the benefits of risk management, and it took time for them to fully understand and use these tools on a regular basis. For buyers of Class I, they really have not had a viable way to manage that risk at a large scale until just recently with the change that was made to the Class I mover in 2019. Since this ability to manage Class I risk is still a very new option for most in the industry, I believe the adoption of risk management in Class I is still in its infancy.

In response to our customer's request to manage volatility in their Class I cost, Schreiber Foods has offered Class I forward contracts to our customers since shortly after the change to the formula was made in 2019. We do currently have Class I forward contracts in place with customers and based on my conversation with customers across our business, I believe the volume of Class I forward contracting will continue to grow. To hedge this exposure, we use several different tools including Class III and Class IV futures and swaps, and Class I swaps.

According to the USDA's announcement on March 8, 2019, the reason for the change was as follows:

> *Currently, the Class I skim milk price is calculated using the higher of the monthly advanced pricing factors for Class III or Class IV skim milk, which reflect dairy product survey prices for the two weeks prior to the price announcement, plus the applicable adjusted Class I differential. Because market prices for these surveyed products fluctuate, the "higher of" factor used to determine the Class I skim milk price can change**, increasing risk and uncertainty associated with hedging.***
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> *To address this issue, Congress determined that the formula for the FMMO Class I skim milk price should be the average of the monthly Class III and Class IV advanced pricing factors plus $0.74 per hundredweight plus the applicable adjusted Class I differential.* [1]

The conditions underlying the need for this change remain, and in fact, are even more significant today than when the change was first made. At the foundation of any effective hedging program is the ability to effectively offset risk in one market with position in another highly correlated market. Prior to the change in the Class I formula, creating an effective hedge of Class I milk was very challenging because the higher of formula meant that when a hedge position was initially put on, it would not be clear whether that should be done with a Class III or Class IV derivative. After the change was made in 2019, it became clear that an acceptable hedge for Class I milk could be achieved by using a combination of both Class III and Class IV derivatives. The increased ability to hedge Class I Milk exposure should be viewed as a favorable thing for end users, processors, and farmers, because it gives everyone in the supply chain the ability to control their market risk in a way that was not previously possible.

I think we can all agree that the world changed dramatically in 2020, and no one could have anticipated the changes through government intervention, and market responses that would take place. The intention of the 2019 change was never for farmers to get a price less than an equivalent to the higher of, but unfortunately that did happen. However, just because unforeseen market conditions caused one part of the market to end up with something different than expected, that doesn't mean the pendulum should swing to the other side and take something away that was agree upon - that is the ability for industry to effectively and efficiently hedge Class I and thus manage risk.

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[1] https://www.ams.usda.gov/content/usda-announces-amendment-class-i-skim-milk-price-formula

There is a way for farmers to be made whole as compared to the higher of formula, and for everyone (farmers, processors, and end users) to get the ability to better manage risk, and that is by maintaining the average of formula and having the formula adjust to the historical difference between the higher of and the current average of formula.

Reverting to the higher of would not just be undoing a change, but it would be undoing that change with full visibility that conditions have changed and that it would put hedgers of Class I milk in a worse situation than what they were in prior to 2020.

Basis is the difference between the price of a physical commodity and the underlying derivative price being used to hedge that commodity.

Looking at data from 2010 to 2019, using either the Class III or Class IV derivative markets basis risk was significant in that the range of basis risk was over $4/cwt from the high to the low with a standard deviation of $.79-1.04/cwt. However, since 2020, if the higher of method was still in place, basis risk would have increased substantially with the range of over $7/cwt. for Class III, over $12/cwt. for Class IV and a standard deviation of $1.63-$3.02/cwt.

Higher of Basis	Min	Average	Max	Range	Std Dev
2010-2019					
Class III	-0.60	0.48	3.80	4.40	0.79
Class IV	-0.53	0.85	4.32	4.85	1.04
2020-present					
Class III	-1.91	1.03	5.21	7.12	1.63
Class IV	-0.94	1.66	11.58	12.52	3.02

As shown in the following table, basis risk is significantly reduced by maintaining the Class III/IV average. While we understand there will be changes to the amount added to the Class III/IV average over time, this additional factor can be incorporated into pricing because it will be known ahead of time and does not affect basis.

Average of Basis	Min	Average	Max	Range	Std Dev
2010-2019					
Class III/IV Avg	0.10	0.72	1.55	1.45	0.21
2020-present					
Class III/IV Avg	-0.42	0.72	2.29	2.71	0.41

Conclusion

In conclusion, proposals 14 and 15 solves for the farmer income issue while still maintaining the lower basis risk that is needed to be able to hedge Class I. There really is an opportunity to have a win-win result, and USDA should seize this opportunity. Thank you for the opportunity to testify.