IDFA TESTIMONY REGARDING THE CLASS I MOVER (aka THE BASE CLASS I SKIM PRICE) PROPOSALS 13-18

HISTORY

- The Class I price equals the Class I mover (the same everywhere) plus the Class I differential (which varies by location).
- From January 2000 through April 2019, the Class I mover each month was the higher of the advanced Class III price or the Class IV price.
- Both IDFA and NMPF came to recognize that this approach created a big problem: it made it nearly impossible to engage in Class I hedging.
- Both processors and end-users of Class I products never knew which product price to hedge because it was impossible to know whether the Class I price at hedge expiration would be based on the advanced Class III price or the advanced Class IV price.

THE EFFORT TO REACH A SOLUTION

- **IDFA and NMPF economists calculated that the “higher of the advanced Class III or Class IV price” was on average $0.74 more than the average of the advanced Class III and Class IV prices. The difference was consistent over the many time frames evaluated.**
- **IDFA and NMPF obtained legislation that changed the Class I mover to the average of the advanced Class III and Class IV prices plus $0.74.**
- **IDFA AND NMPF jointly presented this to Congress as a <u>revenue-neutral</u> way to help both processors and farmers by facilitating hedging.**

Marin Bozic and Matthew Gould’s August 2019 Paper posted on the CME Web site, “Fluid Milk – A Better Hedge”, Noted the Problems with Higher-of Pricing

“Under the previous formula, the “higher of” factor meant either of the two advanced milk prices — Class III or Class IV— could end up driving the Class I skim milk price each month.

A minority of organizations with Class I price exposure chose to hedge by using the highest-priced futures contract –Class III or Class IV – and accepted the basis risk. By the time USDA announced the Class I price, the driver of milk costs may have changed. If so, the hedge underperformed. For many Class I hedgers, the strategy of using futures failed to adequately reduce price risk.

Another small number of hedgers chose to hedge Class I milk exposure by utilizing futures and options. These participants would hedge with the higher-priced futures contract and also pay the premium for an option on the other futures contract. While the strategy was effective at reducing price risk, for many fluid milk buyers it was also cost-prohibitive.

Lastly, a few manufacturers and end-users utilized the OTC markets to hedge Class I price risk. But risk premiums in these markets tended to be prohibitively expensive. In 2018, just 26 million lbs. of the 44 billion lbs. (0.0006%) of packaged milk produced were hedged using OTC Class I milk contracts.”

IDFA AND NMPF IDENTIFIED 7 BENEFITS TO A HEDGEABLE CLASS I MOVER

NMPF and IDFA Dairy Price Risk Management Recommendations

for the Upcoming Farm Bill

Goal: Provide tools needed to allow processors, cooperatives and dairy producers to better manage price risk on all Classes of milk regulated under Federal Milk Marketing Orders (FMMO).

Both IDFA and NMPF support changing the Class I mover from the higher of Class III and Class IV to the simple average of Class III and Class IV, with an adjustment in Class I differentials based on historical relationships between the current and proposed mover.

Changing the Class I mover to the above referenced price format would:

- balance processor desire for better price risk hedging with cooperative and dairy producer desire to maintain FMMO integrity.
- eliminate the uncertain basis that occurs when the mover shifts between Class III and Class IV.
- allow the use of existing Class III and Class IV futures and options to manage Class I price risk with minimal changes to the FMMO system.
- provide several benefits that can result from the ability to hedge longer-term costs for fluid milk products.
- allow processors to manage price risk for dairy beverage ingredients, as they currently can for non-dairy ingredients.
- allow dairy producers to effectively hedge the Class I portion of their producer milk payments, as they currently can for the other portion of their payments.
- encourage and promote the use of dairy ingredients in new fluid milk and dairy-based beverages that meet Class I specifications.

Both IDFA and NMPF support:

- changing the formula for the Class I price from the higher of Class III or IV to the average of Class III and IV plus $0.74 per cwt. for determining the price of Class I skim milk (equivalent to $0.71 per cwt. for the Class I price at 3.5% fat), and
- implementing this change legislatively in the Farm Bill and maintaining it in effect thereafter unless modified by amendment through formal rulemaking under the Agricultural Marketing Agreement Act.

Both IDFA and NMPF support extending the current FMMO forward pricing program for Class II, III and IV milk, recognizing that:

- the use of risk management is now a widely-accepted practice for these classes of milk.
- the FMMO Risk Management Program use would continue to be reported to USDA.

Both IDFA and NMPF agree that effectuating these changes will improve price risk management for Class I milk.

IDFA AND NMPF IDENTIFIED 7 BENEFITS TO A HEDGEABLE CLASS I MOVER

- **“Balance processor desire for better price risk hedging with cooperative and dairy producer desire to maintain the integrity of Federal Milk Marketing Orders.**
- **Eliminate the uncertain basis that occurs when the Class I mover shifts between Class III and Class IV.**
- **Facilitate the use of existing Class III and Class IV futures and options to manage Class I price risk with minimal changes to the Federal Milk Marketing Order system.**
- **Provide several benefits that can result from the ability to hedge longer-term costs for fluid milk products.**
- **Help processors to manage price risk for dairy beverage ingredients, as they currently can for non-dairy ingredients.**
- **Help dairy producers to effectively hedge the Class I portion of their producer milk payments, as they currently can for the other portion of their payments.**
- **Encourage and promote the use of dairy ingredients in new fluid milk and dairy-based beverages that meet Class I specifications.”**

THE CHANGE DID NOT WORK AS PREDICTED

- Due to the pandemic, the Government’s efforts to address the pandemic, and other factors, the value of cheddar cheese and non-fat dry milk diverged significantly.
- As a result, so did the price for Class III milk (cheese) and Class IV milk (nonfat dry milk and butter).
- The current Class I mover formula (the average of the Class III and Class IV milk price plus $0.74) therefore became materially lower than the old Class I mover formula (the higher of the Class III or Class IV milk price).

IDFA PROPOSAL 14 PROVIDES A BETTER APPROACH:

Addresses Changes in the Relationship between Class III and IV Milk

- Keeps The Class I Price consistent with the previous Higher-of mover over time
- Allows for effective and affordable Class I risk management

Pays farmers the average of the advanced Class III and Class IV prices plus whichever of the following is higher:

- $0.74 (the current formula) or
- The amount the farmer would have received historically under the old “higher of” Class III or Class IV formula.

IDFA PROPOSAL 14 PROVIDES A BETTER APPROACH:

- The amount the farmer would have received under the old “higher of” Class III or Class IV formula will be calculated over a two year “look back” period, and that amount will be paid farmers if higher than the $0.74 Floor.

THERE IS A BETTER APPROACH: IDFA PROPOSAL 14

- IDFA Proposal 14 is not based on a prediction of the future relationship between Class III and Class IV prices, but on the actual relationship between Class III and Class IV prices
- IDFA Proposal 14 will pay farmers more over time than they will be paid under either the current Class I mover or NMPF’s proposed return to using the “higher of” Class III or Class IV formula.

EXAMPLE 1: CALENDAR YEAR 2024

- From August 2021 through July 2023, the average difference between the Class III and Class IV advanced prices was $0.95.
- Because $0.95 is higher than $0.74, the Class I mover in all months in calendar year 2024 will be the average of the Class III and Class IV advanced prices plus $0.95.
- Dairy farmers are, through this higher adjustment, being "made whole" over time for the extra amounts they would have received from August 2021 through July 2023 had the Class I mover been based upon the "higher of" the Class III or Class IV advanced price.

Proposal Example: 2024 Mover Adjuster - Effective January 2024

Base Period for 2023	-	-	Class III	Class IV	Higher of III-IV	Simple Avg. III-IV
August-2021		-	10.04	9.67	10.04	9.86
September-2021		-	9.68	9.75	9.75	9.72
October-2021		-	9.90	9.93	9.93	9.92
November-2021		-	11.45	10.53	11.45	10.99
December-2021		-	11.40	11.52	11.52	11.46
January-2022		-	10.73	12.21	12.21	11.47
February-2022		-	10.43	12.97	12.97	11.70
March-2022		-	10.59	13.71	13.71	12.15
April-2022		-	11.97	14.51	14.51	13.24
May-2022		-	13.68	14.82	14.82	14.25
June-2022		-	15.04	14.80	15.04	14.92
July-2022		-	13.07	14.72	14.72	13.90
August-2022		-	11.19	14.83	14.83	13.01
September-2022		-	8.84	13.82	13.82	11.33
October-2022		-	7.04	12.67	12.67	9.86
November-2022		-	9.17	12.61	12.61	10.89
December-2022		-	9.63	11.78	11.78	10.71
January-2023		-	9.54	11.62	11.62	10.58
February-2023		-	10.28	11.00	11.00	10.64
March-2023		-	8.49	9.60	9.60	9.05
April-2023		-	8.46	9.37	9.37	8.92
May-2023		-	10.37	9.08	10.37	9.73
June-2023		-	7.17	8.78	8.78	7.98
July-2023		-	5.33	8.94	8.94	7.14
		-	-	-	-	-
24 Month Average			$10.15	$11.80	$11.92	$10.97
(Rounded to two Decimals)			-	-	-	-

Difference Between the 24 Mo. Average Higher-of III-IV and the 50:50 III-IV

		Higher-Of	- Simple Avg	=Difference
		$11.92	- $10.97	$0.95
2024 Class I Skim Mover Adjuster =	Greater of:	Minimum Base	-or-	Higher of vs Average Of
2024 Class I Skim Mover Adjuster =	Greater of:	$0.74	-or-	$0.95
Class I Skim Mover Adjuster for 2024 = 50:50 Advance III:IV Skim plus				$0.95

EXAMPLE 1: CALENDAR YEAR 2024

- From August 2021 through July 2023, the average difference between the Class III and Class IV advanced prices was $0.95.
- Because $0.95 is higher than $0.74, the Class I mover in all months in calendar year 2024 will be the average of the Class III and Class IV advanced prices plus $0.95.
- Dairy farmers are, through this higher adjustment, being “made whole” over time for the extra amounts they would have received from August 2021 through July 2023 had the Class I mover been based upon the “higher of” the Class III or Class IV advanced price.

EXAMPLE 2: CALENDAR YEAR 2021

- From August 2018 through July 2020, the average difference between the Class III and Class IV advanced prices was $0.70.
- Because $0.70 is lower than $0.74, the Class I mover in all months in calendar year 2024 would be the average of the Class III and Class IV advanced prices plus $0.74.
- Dairy farmers would have been paid $0.04 more than they would have been paid under the "higher of Class III or Class IV" formula during the period August 2018 through July 2020.
- Farmers would ***not*** be required to "give back" the extra $0.04.

The Use of a Price Floor Means Proposal 14 will Out-pay Higher-Of Over Time

Comparison of IDFA and NMPF Base Skim Price Formulas

Year	IDFA Proposal 14	NMPF Proposal 13	Difference
2003	$7.39	$7.47	-$0.08
2004	$8.04	$8.44	-$0.41
2005	$8.67	$8.54	$0.13
2006	$8.29	$7.47	$0.82
2007	$13.59	$13.47	$0.12
2008	$12.42	$12.94	-$0.52
2009	$7.68	$7.40	$0.28
2010	$9.79	$9.26	$0.53
2011	$11.90	$12.02	-$0.13
2012	$11.79	$11.82	-$0.04
2013	$13.71	$13.50	$0.21
2014	$15.48	$15.57	-$0.10
2015	$8.58	$8.91	-$0.33
2016	$7.07	$6.75	$0.32
2017	$7.82	$7.60	$0.22
2018	$6.56	$6.23	$0.32
2019	$8.40	$8.31	$0.09
2020	$11.13	$12.89	-$1.76
2021	$10.83	$10.75	$0.08
2022	$14.01	$13.64	$0.37
2023F	$10.15	$9.39	$0.75
2003-2019	$9.83	$9.75	$0.08
2004-2023	$10.29	$10.25	$0.05

Data Source: Hearing Exhibit USDA 37 & IDFA

IDFA'S ASSESSMENT OF NMPF PROPOSAL 13

NMPF PROPOSAL 13

- **NMPF Proposal 13 would reinstate the old Class I mover formula: the higher of the advanced Class III or Class IV price.**
- **This would eliminate or significantly inhibit each of the seven benefits of the current formula.**

RETURN TO THE HIGHER-OF CALCULATION WOULD ESSENTIALLY ELIMINATE THESE NOTED BENEFITS

- ~~Balance processor desire for better price risk hedging with cooperative and dairy producer desire to maintain the integrity of Federal Milk Marketing Orders.~~
- ~~Eliminate the uncertain basis that occurs when the Class I mover shifts between Class III and Class IV.~~
- ~~Facilitate the use of existing Class III and Class IV futures and options to manage Class I price risk with minimal changes to the Federal Milk Marketing Order system.~~
- ~~Provide several benefits that can result from the ability to hedge longer-term costs for fluid milk products.~~
- ~~Help processors to manage price risk for dairy beverage ingredients, as they currently can for non-dairy ingredients.~~
- ~~Help dairy producers to effectively hedge the Class I portion of their producer milk payments, as they currently can for the other portion of their payments.~~
- ~~Encourage and promote the use of dairy ingredients in new fluid milk and dairy-based beverages that meet Class I specifications.~~

NMPF’S CRITICISMS OF IDFA’S “AVERAGE OF WITH A LOOK BACK” ARE NOT VALID

NMPF CONTENTION:

Using the higher of Class III and IV reduced the incentive for depooling

REALITY: IDFA'S DATA ANALYSIS ESTABLISHES OTHERWISE

IDFA Evaluated the Class Price Relationships of the IDFA and NMPF Mover Proposals:

- Class I: Use IDFA, AND NMPF, Proposed Class I Mover prices at the Minimum Differential Zone $1.60
- Class II, III, IV: Use the Announced Class II, III, IV Prices
- Weighted Price: Use the 5-Year National Utilization Rates for Classes II, III & IV to Determine the Weighted Average Price for all three manufacturing classes.

	Class II	Class III	Class IV
Share of Total Pooled Milk:	12.4%	38.4%	20.0%
Share of Combined II/III/IV:	17.5%	54.2%	28.3%

- Compare the Monthly Announced Class I Price in the $1.60 Zone to the Individual Manufacturing Class Prices along with the weighted average for manufacturing Classes based on 5-Year Utilizations.

REALITY –

The Number of Months when Class I is Lower than the Manufacturing Prices is nearly the same for both the IDFA and NMPF Proposals.

IDFA Proposal 14 - Class I Price + $1.60 Differential Percent of Months Below the Manufacturing Class Prices				
Time Period	% Greater than Class II	% Greater than Class III	% Greater than Class IV	% Greater than Weighted Avg
2018-2022	5.0%	11.7%	1.7%	5.0%
2013-2022	5.8%	6.7%	0.8%	2.5%
Jan 2012 - August 2023	5.7%	8.6%	0.7%	2.1%

NMPF Proposal 13 - Class I Price + $1.60 Differential Percent of Months Below the Manufacturing Class Prices				
Time Period	% Greater than Class II	% Greater than Class III	% Greater than Class IV	% Greater than Weighted Avg
2018-2022	5.0%	11.7%	5.0%	5.0%
2013-2022	5.0%	7.5%	2.5%	2.5%
Jan 2012 - August 2023	5.0%	7.1%	2.1%	2.1%

IDFA Proposal 14 vs. NMPF Proposal 13 Differences in % Months Under Manufacturing Class Prices				
Time Period	% Greater than Class II	% Greater than Class III	% Greater than Class IV	% Greater than Weighted Avg
2018-2022	+0.0%	+0.0%	-3.3%	+0.0%
2013-2022	+0.8%	-0.8%	-1.7%	+0.0%
Jan 2012 - August 2023	+0.7%	+1.4%	-1.4%	+0.0%

NMPF CONTENTION: *Using the higher of Class III and IV reduced volatility*

REALITY: IDFA'S DATA ANALYSIS ESTABLISHES OTHERWISE

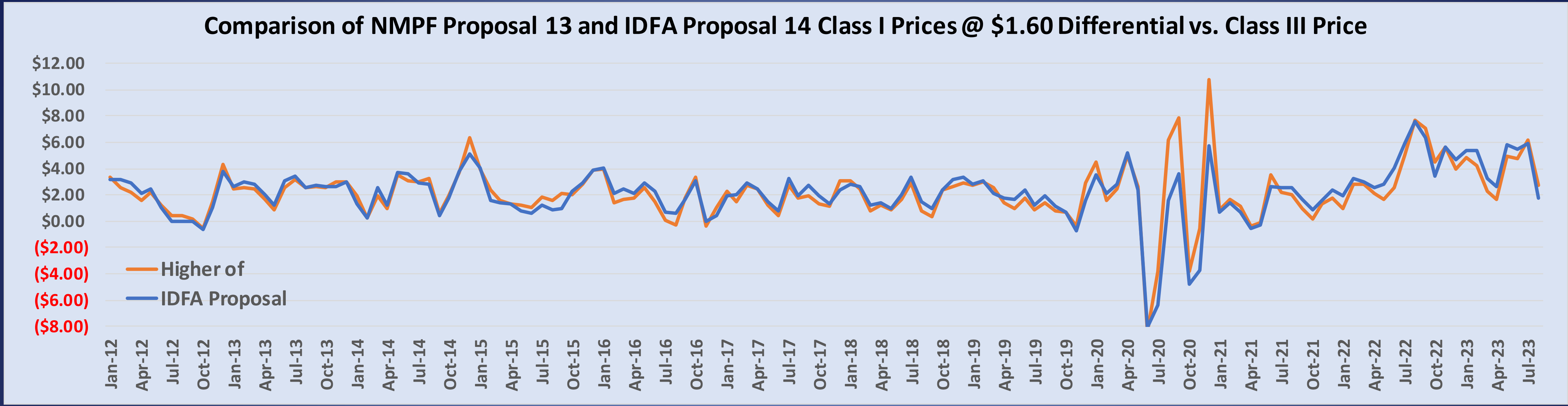
The IDFA Proposal 14 experiences ***less*** volatility in Class Price Differences then NMPF Proposal 13

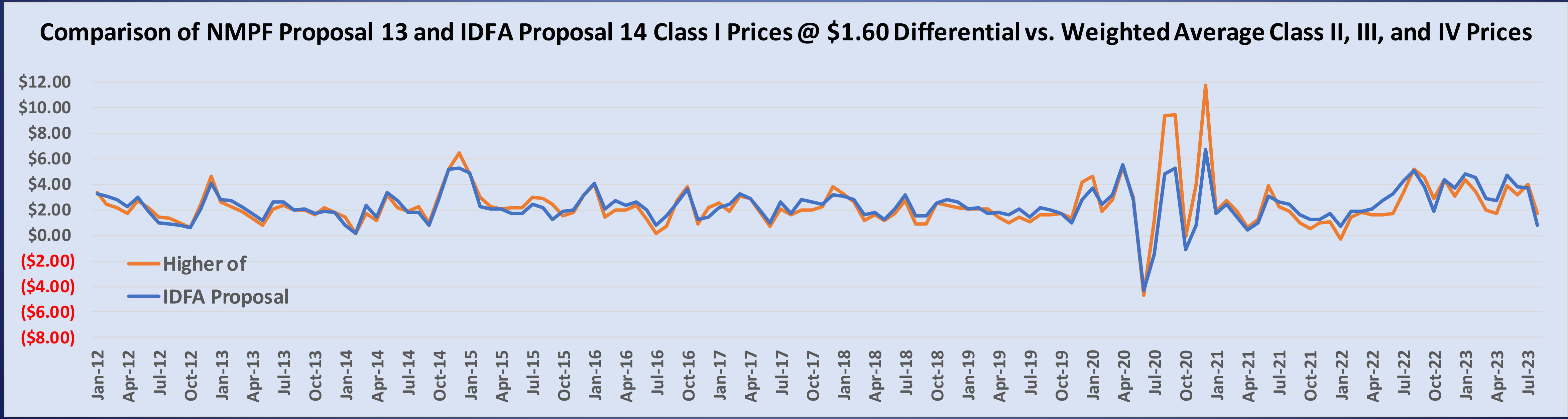
IDFA Proposal 14 - Class I Price + $1.60 Differential Price Variation Statistics than Classes				
Jan 2013 - Dec 2022	Class II	Class III	Class IV	Wtd. Avg. II, III and IV
Average	$2.05	$2.07	$2.77	$2.27
Max	$8.11	$7.58	$8.85	$6.72
Min	-$1.06	-$8.03	-$0.82	-$4.32
Standard Deviation	$1.42	$2.03	$1.67	$1.36

NMPF Proposal 13 - Class I Price + $1.60 Differential Price Variation Statistics				
Jan 2013 - Dec 2022	Class II	Class III	Class IV	Wtd. Avg. II, III and IV
Average	$2.09	$2.11	$2.81	$2.30
High	$12.69	$10.76	$13.43	$11.73
Low	-$1.52	-$8.41	-$1.78	-$4.70
Standard Deviation	$2.15	$2.14	$2.36	$1.84

IDFA Proposal 14 than NMPF Proposal 13 Price Statistics Comparison				
Jan 2013 - Dec 2022	Class II	Class III	Class IV	Wtd. Avg. II, III and IV
Average	-$0.04	-$0.04	-$0.04	-$0.04
Max	-$4.58	-$3.18	-$4.58	-$5.01
Min	$0.46	$0.38	$0.96	$0.38
Standard Deviation	-$0.72	-$0.11	-$0.69	-$0.48

REALITY – How the Differences Chart Out





NMPF CONTENTION:
Using the higher of Class III or IV to set the Class I price sends an important price signal to farmers
REALITY: IDFA'S DATA ANALYSIS ESTABLISHES OTHERWISE

The price signal to farmers is the blend price, not the Class I price.

Nationally, Class I is on average only 29.2% of pooled milk (2018-22 average).

For the past 10 years, from 2012 to 2022, on average:

--the Class I share of the blend price was 31.8% under both IDFA Proposal 14 and NMPF Proposal 13;

-- Under the IDFA proposed Class I skim milk mover, the amount added to the average of the Class III and Class IV price only represented 1.45% of the blend price;

--Under the NMPF proposed Class I skim milk mover, the amount by which the higher of Class III or IV exceeded the average of Class III and IV only represented 1.48% of the blend price.

NMPF CONTENTION:

In some markets the use of a simple or even weighted average of the various manufacturing values may inhibit the ability of Class I handlers to procure milk supplies in competition with those plants that make the higher-valued of the manufactured products.

REALITY:

- We have lived under "average of" for more than four years, since May 2019
- There have been no significant reported problems in Class I handlers obtaining enough milk, except perhaps in the Southeast.
- The Southeast presents a regional issue, which is already being addressed by USDA through its recommended decision addressing transportation credits.

NMPF CONTENTION:
Basing Class I on the higher of III or IV would more accurately reflect the value of (milk in) these different categories of use in a four-class system.

REALITY: IDFA'S DATA ANALYSIS ESTABLISHES OTHERWISE

- The average value of milk is a function of ALL product markets, not just the highest commodity.
- The 2018-2022 average Producer milk utilizations across all Federal Orders by Class are as follows:

  Class I – 29.2%   Class II - 12.4%   Class III - 38.4%   Class IV – 20.0%

- Class II, III and IV prices are not affected by the choice between higher of and average of. Actually the opposite is true, because Class I is determined by Class III and IV Prices.
- IDFA''s "average of" with a look back ensures that shifts in demand for any manufactured product will not lower Class I prices over time; farmers will be paid as much for Class I as they would have under higher of.

NMPF CONTENTION:

***Handers may go out of business and never make the "make up" payments**.*

REALITY:

- The make up obligation is part of price setting, being added into the Class I skim milk mover, and is received by all farmers supplying milk.
- If there is demand for the fluid milk, someone is making those products and making the "make up" payments.
- The make up obligation is part of price setting, being added into the Class I skim milk mover, and becomes an obligation of all handlers.

NMPF CONTENTION: Farmers may go out of business and never receive the make up” payments

REALITY:

Farmers go out of business for many reasons.

The make up obligation is part of price setting, being added into the Class I skim milk mover, and is shared by all farmers supplying milk under the Federal Order.

Farmers who have gone into the dairy business, or expanded production, will receive the higher payments even though this is “new” milk production.

This is no different than the fact that there are also handlers who will go out of business during the period before make allowances have been raised to appropriate levels.

IDFA'S ASSESSMENT OF THE OTHER CLASS I MOVER PROPOSALS

MIG PROPOSAL 15

- Proposal 15 is also designed to facilitate hedging.
- It uses a somewhat different look back period, and a rolling adjuster that would change monthly (rather than annually under the IDFA proposal).
- Proposal 15 would ensure that farmers over time receive as much as they would have under the “higher of” approach, without containing a floor.
- IDFA endorses MIG Proposal 15 as an acceptable alternative should USDA prefer it.

EDGE PROPOSAL 16

- Proposal 16 would set the Class I mover at the Class III skim price, plus an adjuster equal to the 36-month average difference between the higher of the advanced Class III skim price or advanced IV skim price, and the Class III skim milk price.

- The proposal would create a predictable and hedgeable Class I price.

- But while the current mover and proposed IDFA mover announce the advanced Class I price by the 23rd day of the previous month, Proposal 16 delays the announcement of the Class I price until after the pricing month ends.

- For important segments of the business, including most Class I sales to grocery stores, longstanding business practice has been to announce wholesale prices monthly, so that the prices charged in a given month can reflect the actual raw milk costs for that month.

- IDFA opposes Proposal 16 because that advanced pricing knowledge would be lost.

EDGE PROPOSAL 17

- Proposal 17 uses the higher of the actual Class III or IV prices to set the Class I price in a given month.
- The actual Class III and Class IV prices for a given month are not known until as late as the 5th day of the following month.
- Like Edge Proposal 16, Edge Proposal 17 is unacceptable because Class I handlers would have to price their milk products at a time they did not yet know their raw milk costs.
- Edge Proposal 17 is further defective because it would not provide an effective way for Handlers to hedge the not-yet-announced Class I price because they could not know with certainty whether their price would be set by the Class II price or the Class IV price.
- IDA opposes Proposal 17.

AFBF PROPOSAL 18

- Like NMPF Proposal 13 and Edge Proposal 17, AFBF Proposal 18 would re-instate the “higher of” approach to setting Class I prices, thus eliminating any practical ability to engage in hedging.
- Like Edge Proposal 17, AFBF Proposal 18 would make things worse by basing Class I prices on actual Class III and IV prices that are not known until the 5th day of the following month. Thus, all Class I handlers would always have to price their milk at a time they did not yet know their raw milk costs.
- Finally, AFBF Proposal 18 would extend most of these advance pricing difficulties to Class II, by basing the Class II skim price on the actual Class IV price, rather than the current use of the advanced Class IV price.
- IDFA opposes AFBF Proposal 18.