UNITED STATES DEPARTMENT OF AGRICULTURE

BEFORE THE SECRETARY OF AGRICULTURE

AGRICULTURAL MARKETING SERVICE

In re: Milk in the Northeast and Other Marketing Areas	7 CFR Parts 1000 *et seq.* Docket No. 23-J-0067; AMS-DA-23-0031

CARMEL, INDIANA
SEPTEMBER 2023

TESTIMONY OF SALLY KEEFE, PART 3 REGARDING NATIONAL HEARING ON FEDERAL MILK MARKETING ORDER PROPOSALS

September 16, 2023

I. BACKGROUND

I am the owner and principal of skFigures, a company that provides dairy consulting services to all verticals of the dairy industry. I am here today as a representative of the Milk Innovation Group ("MIG").

I received my B.A. in Economics from Middlebury College and my M.B.A. in finance and entrepreneurship from the University of Colorado. Before entering the organic dairy field, I worked as an environmental economics and policy consultant. Beginning in 1996, I worked in Operations and Milk Procurement for Horizon Organic Dairy. I joined Aurora Organic Dairy as Supply Chain Director in 2003 and was a key member of the team who launched that new, innovative organic dairy company. I served in this and other roles in supply chain management before I became the Vice President of Legal & Government Affairs for Aurora Organic Dairy in 2007. I served in this role until 2012. In this capacity, I directed the company's legal, regulatory, and legislative activities, and was active in both the dairy and organic industry arenas.

In 2012, I left Aurora Organic Dairy and founded skFigures. I provide management consulting services as well as technical and policy expertise to agriculture and food businesses. I have particular expertise in Federal Milk Marketing Orders and have testified in prior FMMO proceedings. My clients include farmers, agricultural cooperatives, dairy processors, corporations, trade associations, and investors.

II. SUPPORT FOR MIG PROPOSAL 20

I am a consultant and expert for the Milk Innovation Group ("MIG") and am testifying in support of its Proposal 20 here today. MIG proposes reducing the base Class I differential from $1.60 to $0.00 per cwt.

A. Current Class I Differential

During FMMO reform about 25 years ago, USDA developed and implemented the current Class I pricing structure. At that time, USDA established the base Class I differential at $1.60 per

cwt, along with county-level location adjustments. Currently, the effective Class I differential ranges from $1.60 to $6.00 per cwt. It has four parts:

(1) $0.40 compensation for Grade A status,

(2) $0.60 for the marketing/balancing costs incurred in supplying the Class I market,

(3) $0.60 to incentivize producers to supply milk for fluid use, and

(4) $0.00 to $4.40 county-level location adjustment.

USDA aimed to establish the Class I price differential at the "***lowest value necessary***" to ensure sufficient milk supply for fluid use. USDA acknowledged the concern that setting the Class I differential at too high of a level would "be an incentive to overproduce for fluid needs." Specifically:

> The $1.60 minimum differential level proposed is perceived to be the lowest value necessary under present supply and demand conditions to maintain stable and viable pools of milk for Class I use in markets that are predominantly manufacturing oriented. Applying this minimum differential to each of the three low pricing areas will ensure that low utilization and surplus markets will have similar differentials. However, having a larger portion of Class I value pooled could mute price signals to producers more than prices determined strictly by market forces. If the blend price exceeds the marginal value of milk in manufacturing, there would be an incentive to overproduce for fluid needs.

Milk in the New England and Other Marketing Areas, 63 Fed. Reg. 4802, 4909 (Jan. 30, 1998) (emphasis added).

Of this $1.60 in the Class I Differential, USDA concluded that $0.40 reflected the costs to producers of maintaining Grade A milk status:

> First, a portion of the Class I differential must reflect the value associated with maintaining Grade A milk supplies since this is the only milk available for fluid use. Originally the differential needed to be established at a level that would encourage conversion from Grade B to Grade A status. With approximately 96 percent of all milk already converted to Grade A, this value now needs to reflect the cost of maintaining Grade A milk supplies. Although it may be difficult to quantify the cost to maintain Grade A status, there are specific associated costs, as described below.
>
> . . . .

> . . . Often, this will require additional labor, resource, and utility expenses. It has been estimated that this value may be worth approximately $0.40 per hundredweight.

Id. at 4907–08.

USDA also found that this $1.60 included $0.60 for the marketing/balancing costs incurred in supplying the Class I market:

> Traditionally, the additional portion of the Class I differential reflects the marketing costs incurred in supplying the Class I market. These marketing costs 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 milk plants that service the fluid Class I markets. This value has typically represented approximately $0.60 per hundredweight.

Id.

Finally, USDA determined the remaining $0.60 constitutes necessary compensation to incentivize producers to supply milk for fluid use, rather than manufacturing purposes.

> Option 1A presumes that the [proposed] minimum Class I differential is no longer adequate to ensure a sufficient supply of milk due to the competitive nature of the manufacturing facilities in this region. Thus, Option 1A establishes an additional competitive factor into the development of the base zone Class I differential. Option 1A values this competitive factor to be worth about $0.60 per hundredweight. This value reflects approximately two-thirds of the actual competitive costs incurred by fluid plants to simply compete with manufacturing plants for a supply of milk.

Id. at 4909.

This base Class I $1.60 differential is the starting point of the adjusted Class I differentials found in 7 C.F.R. § 1000.52, with county location adjustments applied atop.

Since Federal Order reform, except in the Southeast (location adjustment changes only), USDA has not updated the underlying structure of the Class I differential, despite the significant shift in FMMO utilization. This basic apportionment of the Class I differential has been affirmed since its establishment, including impliedly with USDA's adoption of the California FMMO, 7 C.F.R. pt. 51. *See also* Hr'g on Promulgation of a Federal Milk Marketing Order in California, Ex. 70 ("Testimony of Dennis Schad"), at 30–32. However, affirmation via the California order

was driven by a desire for national uniformity, not from careful reconsideration of the components of the Class I differential.

MIG does not dispute there is a location value for milk and that the Act requires the Secretary to bring forth an adequate supply of milk for fluid use. But differentials at too high a level result in artificially induced overproduction while reducing fluid milk consumption by consumers (a risk raised by witnesses even during FMMO Reform, 64 Fed. Reg. 16026, 16116 (April 2, 1999)). It is also not in the public interest. Thus, MIG proposes the appropriate and economically justified base Class I differential of $0.00, adjusted for location using the current county price surface.

B. The base Class I differential elements are no longer cost justified.

The cost justifications for the $1.60 base Class I differential elements no longer exist. MIG members and expert Mark Stephenson will speak specifically to each of the elements, in addition to the explanation offered below.

Historically, the $0.40 Grade A compensation mattered given that the cost of maintaining Grade A status was unique to producers supplying Class I processors. Decades ago, there were significant amounts of Grade B milk on the market, and Class III and Class IV products were oftentimes made with Grade B milk. But now nearly all (at least 99% of milk) [1] is Grade A, and Class III and IV products are made with Grade A milk. Exported products like NFDM, butter and cheese must all be Grade A. Exports have dramatically increased since FMMO reform and this change must be considered by AMS. We also have testimony in this hearing from multiple large cheese manufacturers that they do not receive Grade B milk; indeed, at least two of those stopped receiving any Grade B milk just in the last eight years. This shift in manufacturing milk market standards is also a significant change since the Final Decision implementing FMMO Reform. Given that Class III and IV prices are intended to be market clearing, they account for the cost of

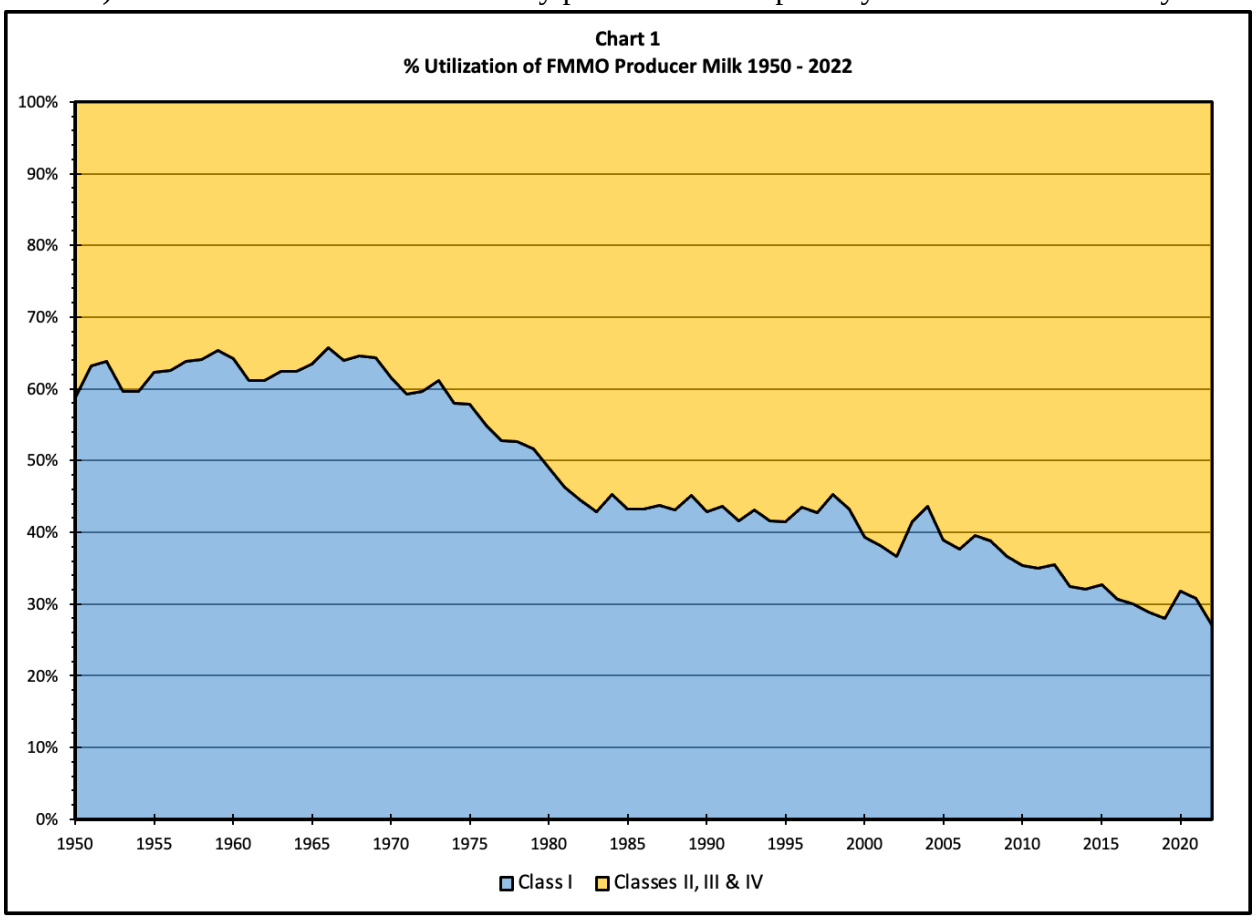
[1] Exhibit MIG 15A: USDA NASS, Milk Production, Disposition, and Income 2022 Summary, April 2023 https://downloads.usda.library.cornell.edu/usda-esmis/files/4b29b5974/79409c30t/6w925r29k/mlkpdi23.pdf

achieving and maintaining Grade A status on the farm. The Class I price is built from the Class III and IV prices, so including $0.40 as compensation on top of the Class III and IV prices is an unjustified "double dip" for Grade A milk. The Grade A compensation portion of the Class I differential is antiquated and discriminatory now that virtually all milk is Grade A, and USDA should eliminate this element of the base Class I differential.

Market efforts at balancing have also changed over the last 25 years since the federal order reform. Market balancing costs do not belong in the regulated minimum price because market balancing costs are not always borne by producers and/or cooperatives. Sometimes these costs are borne by *producers*, but other times by *processors*. For example, longer storage time for extended shelf-life products allows processors to manage supplies and inventory to balance the market (at a cost to the processor). In other scenarios, the processor may accept even day receiving and remain open to receiving milk on weekends or holidays. Balancing arrangements can also vary regionally. Finally, Class I processors will testify that producers and/or cooperatives are negotiating (and receiving) over-order premiums for balancing costs. That means that Class I processors are effectively paying for balancing twice, once diluted through pool payment and then a second time to the producers actually supplying the milk to fluid plants. Just like the Grade A issue, USDA should not require this duplicative cost of Class I processors.

When balancing costs are built into the minimum price, it creates disorderly marketing. In the first instance that means Class I processors are paying for balancing services that they may not be receiving. In the second instance, being forced to pay into the pool generally for balancing leaves Class I processors with fewer resources to pay their direct suppliers over-order premiums related to balancing. The myriad of situations in which a processor and/or a cooperative and/or a producer can provide and bear the costs of balancing demonstrates it does not belong in the regulated minimum price. In any event the market can, should, and does price balancing services. Thus, USDA should eliminate this from the base Class I differential.

Finally, the presumption that a pool-wide "incentive" is necessary to attract milk for fluid use from manufacturing use no longer holds in today's marketplace. A recent report by the Congressional Research Service notes that one of the main objectives of FMMOs are to "promote orderly marketing conditions in fluid milk markets."[2] The federal orders were conceived at a time when the fluid use of milk represented about two-thirds of the utilization in FMMOs and both the problems and the solutions were built around fluid milk processing and consumption. Today, less than one-third of FMMO utilization is Class I and less than 20% of all usage (FMMO and non-FMMO) is fluid milk. Manufactured dairy products are the primary use of farm milk today.



MIG approached this factor by analyzing what level, if any, of monetary incentive is necessary to attract milk from manufacturing use to fluid use. MIG asked Dr. Mark Stephenson

[2] Congressional Research Service, *Federal Milk Marketing Orders: An Overview*, June 15, 2022. https://crsreports.congress.gov/product/pdf/R/R45044/5 (emphasis added)

to use the U.S. Dairy Sector Simulator model to evaluate the value of the milk for fluid use relative to manufacturing use. The national average of this simulation was *a negative number*. In other words, this research demonstrated that, at a national level, fluid milk plants have no need to compel the production of more milk in order to ensure a sufficient supply of fluid milk. Therefore, the fluid incentive embedded in the Class I differential is not cost justified and should be eliminated.

C. The Solution for Failing Class I Market is Less Regulation.

Albert Einstein is credited with having first said: "The definition of insanity is doing the same thing over and over again but expecting different results." The current system is not working and leaving it in place will leave Class I on its current downward trajectory. Even worse, the package of NMPF proposals would *increase* Class I prices relative to manufacturing products prices and hasten the devastating decline of Class I sales.

The world and the dairy industry have changed since FMMO reform 25 years ago. No one in dairy is served by ignoring today's reality. USDA should recognize that:

- Grade B milk is irrelevant to FMMO pricing and should not be considered in setting base Class I differential;
- Balancing is now paid for both by processors directly through plant, warehouse, and inventory investments and through direct payments to suppliers; and
- For significant regions of the country, milk is more valuable in cheese than as packaged fluid milk.

Given the volume of total milk in relation to fluid utilization the $1.60 base Class I differential is not necessary on a national, market-wide basis. It is instead counterproductive and market distorting. It leads to fluid milk processors paying for the same services twice – once through the regulated minimum and then again directly to their cooperatives/producers. No one in dairy, producer and processor alike, benefits from an ever-shrinking Class I market. Maintaining high levels of regulation is both unnecessarily expensive and will likely lead to further erosion of Class I sales. We need a new vision and new approaches.

III. ESTIMATED CLASS I AND UNIFORM PRICE CHANGES

If each element of MIG's proposal is adopted, then the base Class I differential would be reduced by $1.60 per cwt uniformly for every county in the 48 contiguous states. Using 2022 annual average Class I utilization, MIG estimates that its proposal would reduce uniform producer prices by $0.43 per cwt.

Table 1

Estimated Class I and Uniform Price Changes by FMMO

FMMO	Class I Price Change ($/cwt)	2022 Wt. Avg. FMMO Class I Utilization (%)[1]	Uniform Price Change ($/cwt)
1 (Northeast)	-$1.60	29.62	-$0.47
5 (Appalachian)	-$1.60	70.43	-$1.13
6 (Florida)	-$1.60	83.01	-$1.33
7 (Southeast)	-$1.60	72.40	-$1.16
30 (Upper Midwest)	-$1.60	6.88	-$0.11
32 (Central)	-$1.60	27.90	-$0.45
33 (Mideast)	-$1.60	36.98	-$0.59
51 (California)	-$1.60	21.07	-$0.34
124 (Pacific Northwest)	-$1.60	21.40	-$0.34
126 (Southwest)	-$1.60	28.17	-$0.45
131 (Arizona)	-$1.60	27.12	-$0.43
FMMO Wt. Average	-$1.60	27.03	-$0.43

[1] Source: https://www.ams.usda.gov/sites/default/files/media/ClassIUtilization2022.xlsx

IV. REGULATORY LANGUAGE

This proposal amends 7 C.F.R. § 1000.52, adjusted Class I differentials, as shown in Exhibit MIG 15B. As described above the Class I differential adjusted for location for each county/parish/city listed is $1.60 lower than current.

V. CONCLUSION

It is far past the time for the base Class I differential to be reconsidered in light of market changes, including the exploding growth of dairy beverage alternatives, the ongoing precipitous decreases in both absolute volume and per capita fluid milk consumption, and the substantial growth of non-fluid dairy products often sold in the export market. As discussed above and in the testimony of Dr. Stephenson that follows mine, the three elements making up the base Class I differential (Grade A costs, balancing, and incentive to pull milk from manufacturing) are no longer applicable in 2023 – all these factors have changed dramatically since FMMO Reform. They actually cause or contribute to disorderly marketing rather than solving it. They should be eliminated.

DATED this 16th day of September, 2023.

By */s/ Sally Keefe*
SALLY KEEFE