UNITED STATES DEPARTMENT OF AGRICULTURE

BEFORE THE SECRETARY OF AGRICULTURE

AGRICULTURAL MARKETING SERVICE

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

CARMEL, INDIANA
JANUARY 2024

TESTIMONY OF SALLY KEEFE, PART 5 REGARDING NATIONAL HEARING ON FEDERAL MILK MARKETING ORDER PROPOSALS

January 29, 2024

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 policy 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.

I am an expert consultant for MIG and support its proposals at this hearing. I am testifying in opposition to AFBF's Proposal 21 here today. MIG's position is that USDA should not adopt Proposal 21 as it is not an equitable nor justifiable approach to determining the Class II differential.

II. USDA SHOULD REJECT PROPOSAL 21

A. Class I and Class II are uniquely linked.

Class II utilization is important to fluid processors, namely because Class I products will inherently have excess cream that must either be sold, typically to a Class II or Class IV manufacturer, or made use of. Class I processors use the excess cream that fluid milk generates in

a variety of ways. It is common for a fluid plant to bottle both Class I fluid milks and Class II fluid creams as well as other beverages that are also part of Class II. Additionally, many fluid plants have Class II lines for production of cottage cheese, sour cream, yogurt, ice cream mix, etc. Conversely, it is also relatively common today for Class II plants to not bottle fluid milk – *i.e.*, standalone Class II manufacturers are more prevalent than they were historically.

Class II includes milk used for a diverse array of dairy products. As detailed at 7 CFR § 1000.40 (b), Class II includes skim milk and butterfat used for:

- Fluid cream products such as half and half and whipping cream;
- Soft, semi-solid, and frozen products such as cottage cheese, ice cream, sour cream, and yogurt including beverage forms of these;
- Products for infant feeding or dietary use (meal replacements); and
- Products for commercial food processing such as large format fluid milks and sweetened condensed milk.

Importantly, 7 CFR § 1000.40 (b)(2)(ix) states that Class II includes skim milk and butterfat used for "(a)ny product not otherwise specified in this section." Thus, Class II milk includes any use which is not explicitly Class I, III, or IV.

This link between Class I and II is largely out of a fluid processor's control because of the relatively low butterfat utilization of Class I fluid milk as determined by consumer preferences for skim, 1% lowfat, 2% reduced fat, and whole milk. As shown in Table 1 below, Class I is the only class with butterfat percentages consistently and significantly below that of FMMO milk in total (*i.e.*, producer milk).

Table 1 Butterfat Percentage of FMMO Milk by Class 2013-2022					
Year	**Class I**	**Class II**	**Class III**	**Class IV**	**Total**
2013	1.87%	7.38%	3.82%	5.51%	3.76%
2014	1.90%	7.72%	3.80%	4.72%	3.74%
2015	1.94%	7.18%	3.85%	4.31%	3.75%
2016	1.99%	7.26%	3.77%	4.33%	3.77%
2017	2.04%	7.42%	3.81%	4.20%	3.82%
2018	2.10%	7.68%	3.90%	4.07%	3.88%
2019	2.16%	8.14%	3.82%	4.05%	3.90%
2020	2.25%	7.68%	4.15%	3.74%	3.92%
2021	2.25%	7.79%	4.12%	3.74%	3.97%
2022	2.27%	8.91%	3.99%	4.71%	4.06%
Source: Exhibit 44, Producer Milk Components by Class and Order January 2008 – April 2023.					

These facts all make clear that any Class II-specific proposal will significantly impact fluid processors if adopted.

B. Class I processors will be unfairly subject to the increased Class II differential in a way that will not impact standalone Class II processors.

If adopted, AFBF's Proposal 21 would create winners and losers – in short, Class I would again be the loser. Under Proposal 21, standalone Class II processors would be able to depool when economically rational, while Class I processors with Class II manufacturing would always be subject to pooling. While the pool plant provisions vary modestly across the orders, generally distributing plants with 25% or more Class I utilization of milk receipts and at least 25% of Class I sales within the applicable marketing area are fully regulated pool plants. Fully regulated distributing plants are mandatory FMMO participants. As such, pooling includes all milk used by the distributing plant – even the non-Class I utilization. In contrast, participation for a standalone Class II plant is voluntary. Like other non-fluid participants, they pool when it is economically rational to do so.

The unfairness here is that a fluid plant making Class II products that meets the typical 25% thresholds would be subject to pooling *at all times* for *all of its milk.* Adoption of Proposal 21 would not change the mandatory participation of fully regulated distributing plants and the voluntary participation of others including standalone Class II operations. This disparity would leave competitors inequitably and unfairly positioned in the marketplace. Standalone Class II processors would have an economic advantage over Class I processors making Class II products. FMMOs cannot and should not regulate identical products differently.

Certainly, this disparity already exists today, and it is worthwhile to consider long-term the place of the Class II differential with FMMO pricing. But without doubt, there is no reason to increase the Class II differential given the unfair impact doing so would have on fluid processors. Proposal 21 is going to make it more difficult for distributing plants with Class II products to continue to compete in the marketplace against standalone Class II operations, and all because of an unequally applied regulatory burden. USDA must reject Proposal 21.

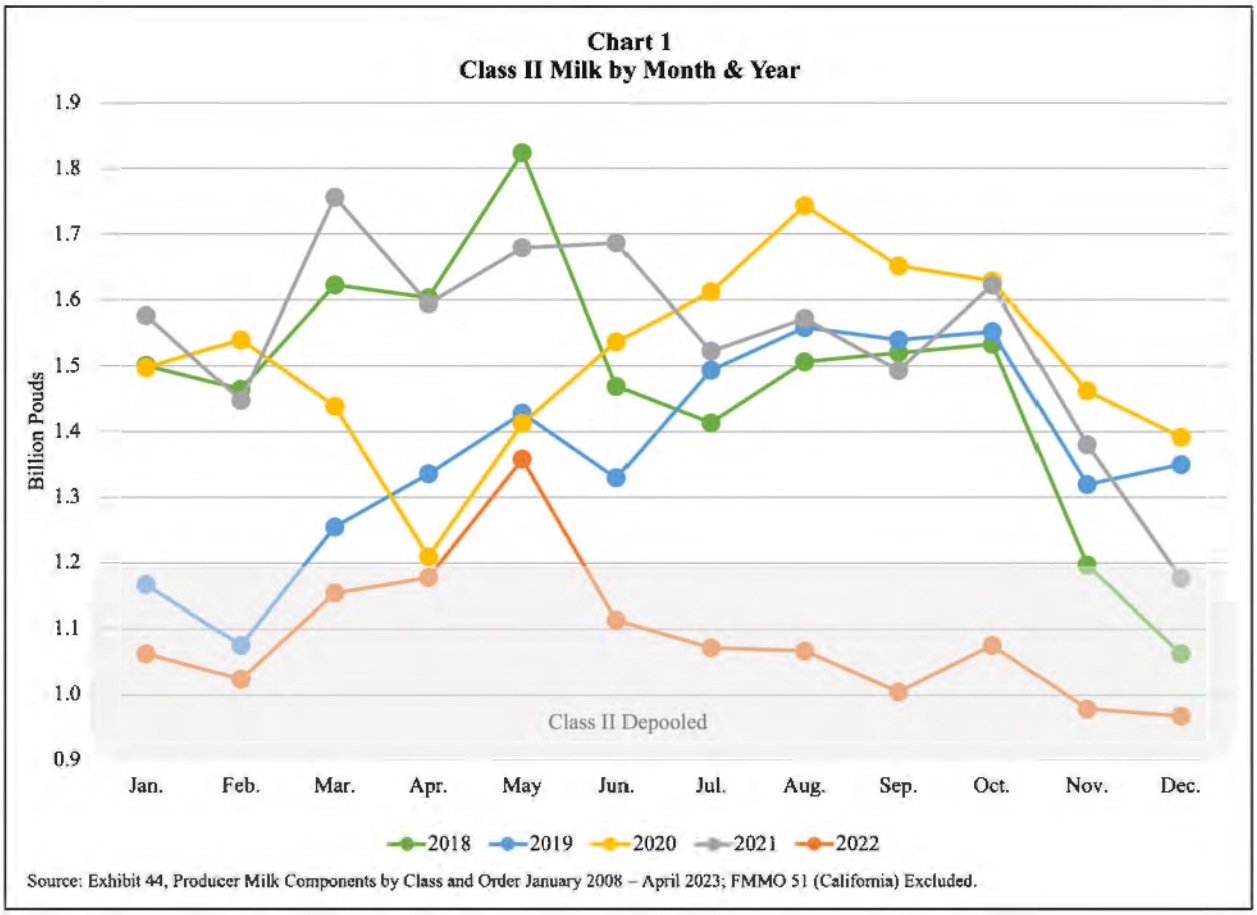
C. Adoption of Proposal 21 would lead to disorderly marketing.

Not only would AFBF's proposed increase in the Class II differential unfairly impact Class I, but the increase would also create disorderly marketing within the marketplace as a whole. AFBF seeks to increase the Class II differential from $0.70 / cwt to $1.56 / cwt – more than *doubling* the Class II differential. This large increase would encourage substitution of Class IV ingredients for Class II milk in Class II products with particular ingredient formulations and standards of identity.[1] It would also change the pool / depool decision for Class II.

Even AFBF recognizes that adoption of Proposal 21 "could increase the likelihood of depooling Class II milk, when the Class II price is above the uniform price…" However, they

[1] Tim Galloway (Ex. 439, IDFA 63), Jacob Schuelke (Ex. 485, MIG 19A), Tim Doelman (Ex. 488, MIG 26A), Mike Brown (Ex. 489, IDFA 64), Carl Rasch (Ex. 499, NMPF 113), and Steve Galbraith (Ex. 501, IDFA 66) have provided detailed analyses and extensive testimony regarding Class II / IV dynamic and Proposal 21.

claim that since "…much Class II use is at distributing plants, Class II milk is less subject to depooling based on price relationships than other Classes."[2] This statement proves the point above that distribution plants are captive to the FMMO system for all utilization, Class II included). However, monthly FMMO Class II milk volumes show that AFBF's claim is wrong and that Class II milk is indeed routinely depooled. As illustrated by Chart 1 below, conservatively Class II milk was depooled in 22 to 28 percent of months during the 60-month period, January 2018 to December 2022 (i.e., 13 to 16 of the 60 months).



Depooling decisions are made based on the particular circumstances of the handler and the FMMO they are regulated by. Depooling is determined not only by price but also FMMO utilization and its corresponding effect on the uniform price as well as pool qualification

[2] Roger Cryan, Exhibit 383 (AFBF 5A), AFBF Response to Proposals 19 and 20, p. 2.

requirements, etc. Monthly average FMMO milk volumes by class and order are shown in Table 2 below. Class utilization and total pool volume vary across the 11 FMMOs. On the average, Class II utilization ranges from five to 24 percent. Like pool volume and utilization, pooling rules and qualification requirements also vary across the orders.

Table 2
Monthly Average Class Utilization by FMMO 2018 – 2022

	I	II	II	IV	Total	I	II	III	IV	Total
FMMO	**(billion pounds)**					**(percentage)**				
1 Northeast	0.69	0.54	0.60	0.41	2.24	31%	24%	27%	18%	100%
5 Appalachian	0.32	0.06	0.03	0.04	0.45	71%	14%	6%	10%	100%
6 Florida	0.17	0.03	0.00	0.00	0.21	83%	14%	1%	2%	100%
7 Southeast	0.27	0.07	0.02	0.03	0.39	70%	17%	5%	8%	100%
30 Upper MW	0.22	0.11	1.83	0.11	2.26	10%	5%	81%	5%	100%
32 Central	0.38	0.13	0.47	0.26	1.23	31%	10%	38%	21%	100%
33 Mideast	0.54	0.28	0.50	0.22	1.53	35%	18%	32%	14%	100%
51 California*	0.42	0.12	0.59	0.83	1.95	21%	6%	30%	43%	100%
124 Pac. NW	0.14	0.04	0.24	0.24	0.66	21%	6%	37%	36%	100%
126 Southwest	0.34	0.10	0.36	0.27	1.07	32%	10%	34%	25%	100%
131 Arizona	0.11	0.04	0.10	0.15	0.40	27%	10%	25%	38%	100%
FMMO Total	3.53	1.49	4.63	2.42	12.07	29%	12%	38%	20%	100%

Source: Exhibit 44, Producer Milk Components by Class and Order January 2008 – April 2023.
* FMMO 51, California, became effective November 2018.

If proposal 21 were adopted, for those handlers able to do so, depooling of Class II milk would most likely increase. As noted by AFBF, increasing the Class II differential to $1.56 per cwt would increase the months when the Class II price would be expected to exceed the uniform price for many orders.

III. REMARKS REGARDING ADVANCED PRICING AND ORGANIC PRICING

A. Class I Advanced Pricing Pre-Order Reform

Today both the Class I skim milk and butterfat prices are advanced, meaning that the price for each month is announced before the start of that month. Each month, the Class I prices are announced on or before the 23rd day of the prior month and are computed using the most current two weeks of commodity survey price data available. This has not always been the case. In 1972, the FMMOs were amended to establish advanced pricing of the skim milk portion of Class I. The decision[3] stated:

> The rapidly changing structure of the milk distribution industry throughout the United States makes it desirable that handlers be notified at reasonable period in advance of changes in the price they must pay for Class I milk.

While some advocated for also advancing the Class I butterfat differential, that change was not made then. Specifically, the decision noted:

> The Class I butterfat differential changes infrequently. This is because the Chicago butter price quotations, which are strongly influenced by the prices paid for butter by the Government under the price support program, do not vary significantly from month to month. Consequently, there is no compelling need to advance the Class I butterfat differential announcement in connection with the adoption of advance Class I pricing.

At the time of Order Reform, the butterfat differential for the preceding month was still announced on or before the fifth day of the current month. As testified to by other witnesses, this lack of advanced pricing for the butterfat differential was burdensome for the industry. To address that issue, during federal order reform USDA aligned the timing for Class I butterfat and skim prices. With respect to Class I, the order reform final decision[4] stated:

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[3] Milk in the Boston Regional and Certain Other Marketing Areas; Decision on Proposed Amendments to Marketing Agreements and to Orders, 37 Fed. Reg. 1388 (January 28, 1972).

[4] Milk in the New England and Other Marketing Areas; Decision on Proposed Amendments to Marketing Agreements and to Orders; Proposed Rule, 64 Fed. Reg. 16095 (April 2, 1999) (emphasis added).

> Announcement of Class I butterfat and skim milk prices in advance eliminates current problems caused by calculating the butterfat differential after the month for which it is effective. ***Handlers will have true advance Class I pricing.***

Witnesses, including me, have noted throughout this proceeding that advanced pricing remains important for Class I handlers today. Advanced pricing underpins the standard terms of trade for traditional HTST segment of Class I fluid milk.

B. Organic Milk Pricing

USDA raised some questions regarding the methodology for organic prices. Given my long history in that marketplace I wanted to provide some background and context for how pricing works for organic milk. Fundamentally, organic milk prices are not pegged to conventional milk prices because the two marketplaces are distinct – it would be akin to agreeing to tie the conventional milk price to the price of pork. There may be similar inputs, like labor, energy, fuel, etc., but at heart they are just two different marketplaces.

The organic and conventional dairy markets are distinct due to organic milk's unique production requirements. After emerging in the 1980's, the organic market expanded rapidly following passage of the Organic Foods Production Act in 1990 and issuance of the final rule establishing the USDA National Organic Program in 2000. From the beginning organic dairy farmers have sought stable prices to: (1) cover the high cost of organic milk production, (2) provide funds to maintain and grow their operations, and (3) better facilitate business planning. While the FMMOs pre-date organic's emergence, organic farm milk prices are unrelated to conventional FMMO prices.

The organic milk price is not simply structured as a premium over conventional because the cost of production for organic dairy farmers is determined by the inputs and practices required of certified organic dairy farmers – namely, *organic* feed and the cost of replacing *organic* animals. Dr. Juan Velez's testimony described the organic producers' cost of production in detail, including feed, labor, operations, and replacements. Organic production costs are not only higher than conventional but also do not necessarily track with conventional.

I also have an example to share of a failed attempt to tie the organic milk price to the FMMO minimum price. In the mid to late 1990's, there was an organic milk supply in the Northeast, primarily located in New York, that was priced using the New York–New Jersey (Order 2) uniform (blend) price plus an organic premium. This organic milk was affiliated with Elmhurst's Worcester Creamery and was the primary supply for their Juniper Valley brand. In 1998 Horizon Organic Dairy (Horizon) acquired Juniper Valley from Elmhurst. At the time, I was responsible for milk procurement, fluid co-packing, and balancing for Horizon.

This price structure with an organic premium over conventional was not aligned with either the organic handler's or organic producers' needs. For the organic producers, the FMMO conventional blend plus organic premium pricing was too volatile. Worse, while not perfectly counter cyclical, too often this structure provided low organic milk prices when organic feed costs were high. Ultimately, Elmhurst found itself unable to attract the organic milk supply necessary to meet Juniper Valley's needs using the conventional plus organic premium structure. Organic Valley|CROPP Cooperative, The Organic Cow of Vermont, and Horizon offered a stable, fixed prices for organic milk and were out-competing Elmhurst's program in the countryside. Fundamentally, the problem was that Elmhurst's organic milk pricing structure was reflecting the conventional market and not responding to the organic market.

IV. CONCLUSION

Proposal 21 must be rejected as it would promote rather than relieve disorderly marketing. It would create perverse incentives to substitute dried dairy ingredients for farm milk in Class II manufacturing. An increased Class II differential disadvantages processors that make Class II products in pool distributing plants. Dairy has seen remarkable innovation with Class II products, as testified to by MIG member Tim Doelman. The regulatory structure should support, not hinder, this innovation, particularly for the struggling Class I sector. Encouraging growth and diversity in

offerings will benefit the industry as a whole, and rejecting Proposal 21 is consistent with the type of regulatory approach USDA should take to further support the dairy industry.

DATED this 29th day of January, 2024.

By */s/ Sally Keefe*
SALLY KEEFE