Testimony of Christian Edmiston

Land O'Lakes, Inc.

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My name is Christian Edmiston and I am Vice President of Procurement at Land O'Lakes. I have worked in the dairy industry for over 20 years, including roles with Informa Economics, Kraft Foods, and Land O'Lakes. My primary areas of responsibility have been procurement and sales of dairy products such as milk, cheese, butter, whey, and cream, as well as dairy commodity market analysis and risk management. I have personally bought and sold milk and other dairy products for my employers, and also draw upon the experience of others within Land O'Lakes that have done the same. I have served on committees and represented my employers with the International Dairy Foods Association (IDFA), National Milk Producers Federation (NMPF), Chicago Mercantile Exchange (CME), and American Dairy Products Institute (ADPI).

Land O'Lakes is a dairy cooperative with 1,200 dairy farmer member-owners. Land O'Lakes has a national membership base, whose members are pooled on five different Federal Orders. Land O'Lakes members own several cheese, butter-powder and value-added plants in the Upper Midwest, East and California.

Land O'Lakes thanks the Department for calling this hearing to consider the modernization of Federal Orders.

I present this testimony on behalf Land O'Lakes, Inc. Land O'Lakes fully supports the National Milk Producers Federation, hereafter NMPF, and is submitted in support of NMPF Proposal Number 7.

More specifically, Land O'Lakes supports the NMPF proposal to increase the manufacturing cost (make) allowances in the butterfat, nonfat solids, protein, and other solids component formulas as follows:

- Butterfat: From $0.1715 to $0.2100 per pound of butter,
- Nonfat Solids: From $0.1678 to $0.2100 per pound of nonfat dry milk,
- Protein: From $0.2003 to $0.2400 per pound of cheddar cheese, and
- Other Solids: From $0.1991 to $0.2300 per pound of dry whey.

The proposed changes would equate to the following increases:

- an increase of $0.0385 per pound in the butter make allowance,
- an increase of $0.0422 per pound in the nonfat dry milk (NFDM) make allowance,
- an increase of $0.0397 per pound in the cheddar cheese make allowance, and
- an increase of $0.0309 per pound in the dry whey make allowance.

Land O'Lakes acknowledges that these increases, if implemented, would not fully offset the increases in manufacturing costs for commodity-style butter, NFDM, cheddar cheese and dry whey experienced by our manufacturing plants since 2008, when the current make allowances were implemented. Instead, these increases offer a balance between the producer price impact from raising make allowances and the processor cost impact of raising make allowances.

These increases reflect the current cost of manufacturing commodity-style butter, nonfat dry milk, cheddar cheese and dry whey more closely than current make allowances. Increasing make allowances to these levels strikes a balance between updates that are needed as a result of disorderly marketing conditions detailed later in this testimony, and dairy producer profitability. Raising make allowances to levels above these proposed levels will reduce producer prices and would narrow producer margins on the farm that could negatively impact the availability of adequate supplies of milk, and thereby also create disorderly marketing.

At the same time, the proposed increases in make allowances will not ensure that all commodity manufacturing plants will operate profitably. Commodity manufacturing plants vary by location, size, age, depreciation, yield, and other factors. Indeed, the Department recognizes that make allowances need to be established at levels that "…will not provide enough of an allowance to assure that every processor, no matter how inefficient or high cost, will earn a profit."[1]

Raising make allowance to ensure that all commodity manufacturers earn a profit would effectively eliminate the "incentive to make a sufficient quantity of milk available for fluid use, a basic goal of Federal Orders."[2]

In my testimony I will speak to the following points:

1. **Commodity manufacturing costs have increased by any measure since 2006 and exceed the current make allowances for all four commodities.**
2. **Outdated, undervalued, inadequate make allowances have led to and will continue to lead to disorderly marketing conditions.**
3. **Producer impacts of increasing make allowances must be taken into account by USDA**
4. **The industry needs a mandatory, audited, survey of commodity manufacturing cost to provide data to use in discussions to propose updates to the make allowances.**

1. Commodity manufacturing costs have increased by all measures since 2006 and exceed the current make allowances for all four commodities.

Actual, audited manufacturing cost data from plants making the four commodity products represents the ideal data for USDA to use in establishing make allowances. Since no data has been collected by mandate, audited, and reported that covers the relevant population of plants processing these four commodity products, USDA should consider actual cost data voluntarily submitted by processors who manufacture these commodity products.

Land O'Lakes operates two manufacturing plants that produce branded butter and commodity-style NFDM. These plants are located in Tulare, California and Carlisle, Pennsylvania. The Tulare plant is regulated under Federal Order 51 and the Carlisle plant is regulated under Federal Order 1. Combined, our Tulare and Carlisle plants process approximately 13 million pounds of producer milk per day. The manufacturing costs per pound of commodity product at both plants have increased since 2006, as shown in the tables below.

[1] 65 Fed. Reg. 76,840 (Dec. 7, 2000).
[2] Id. at 76,841.

Butter & NFDM cost comparison to Stephenson Survey

Butter Solids basis (Tulare and Carlisle combined)	2007* Stephenson survey weighted averages	% Increase of 2022 LOL costs vs. 2007 Stephenson
Processing Labor	$0.0522	**50%**
Utilities	$0.0157	**33%**

NFDM Solids basis (Tulare and Carlisle combined)	2007* Stephenson survey weighted averages	% increase of 2022 LOL costs vs. 2007 Stephenson
Processing Labor	$0.0362	**38%**
Utilities	$0.0409	**36%**

Butter & NFDM Solids basis (Tulare and Carlisle combined)	2007* Stephenson survey	% increase of 2022 LOL costs vs. 2007 Stephenson
All Other	$0.1009	**112%**

*In 2008, USDA used the Stephenson and CDFA surveys to determine butter and NFDM make allowances.

Land O'Lakes also operates a cheese plant in Kiel, Wisconsin. We have made significant investments in this plant to update the cheese and whey processing facilities, which has led to increased manufacturing costs per pound of cheese and per pound of dried whey since 2006.

Stephen Cain, NMPF economist, conducted an analysis that uses cost indexes to update commodity manufacturing costs from the 2006 levels. The results of that analysis show that commodity manufacturing costs have increased since 2006 and that the current make allowances need updating to reflect these increased costs. Dr. Bill Schiek was also commissioned by IDFA to conduct similar analysis, which likewise shows that commodity manufacturing costs have increased since 2006 and shows that current make allowances need updating.

The voluntary surveys conducted by Dr Mark Stephenson using 2018 and 2022 costs provide more data that shows commodity manufacturing costs have increased since 2006.

In summary, it is clear that manufacturing costs have increased since 2006. This confirmed by Land O'Lakes data, efforts to update past cost surveys, and recently conducted voluntary cost surveys. However, the ideal data that would be provided by a mandatory and audited survey does not exist today.

2. Outdated, undervalued, inadequate make allowances have led to disorderly market conditions.

Under Federal Order Reform, Product Price Formulas (PPF) replaced the previous direct survey of prices paid for manufacturing grade milk. PPFs moved the process of establishing the basis for Federal Order pricing up the marketing chain one step to survey unregulated plants buying and selling of wholesale, spot, commodity-style, dairy products. The dairy products referenced in the Class III and Class IV milk

pricing formulas are primarily commodity products, not retail or branded products. Those dairy product prices became the foundation, working backward via economic formulas, to determine the minimum price of milk used to make the four commodity dairy products. Adjusting the survey prices by subtracting the non-milk costs of manufacturing these products and applying appropriate yield factors determines an implied value for the components of milk used to produce them.

Having accurate and updated plant processing costs, or "make allowances," and appropriate product yield factors are critical for this indirect method of determining milk prices, which is a principal function of the Federal Order Program[3]. Yet a regular and systematic method of ensuring that these critical PPFs remain accurate and current has not been established. More importantly PPFs do not work as they were designed to when make allowances are not reflective of actual costs.

The Department noted the importance of accurate and up-to-date make allowances in determining minimum classified values of milk:

> "Accordingly, the accuracy of deriving the minimum value of raw milk is dependent on the accuracy of the commodity sale prices reported and, in large part, the accuracy of the manufacturing cost factors, or make allowance factors, that are used in the pricing formulas."[4]

When make allowances are undervalued disorderly market conditions ensue, including:

- Lack of investment in manufacturing plants to process and balance milk supplies
- Inequitable pay prices to producers participating in the same market

Inadequate make allowances challenge manufacturing operations' abilities to pay minimum announced milk prices and still operate at reasonable, competitive rates of return. Inadequate make allowances discourage plant investments needed to meet milk supply and product demands on a daily, seasonal, and annual basis. As the Department noted in its Final Decision on Federal Order Reform in 1999:

> "The importance of using minimum prices that are market-clearing for milk used to make cheese and butter/nonfat dry milk cannot be overstated. The prices for milk used in these products must reflect supply and demand and must not exceed a level that would require handlers to pay more for milk than needed to clear the market and make a profit." [5]

When manufacturing costs of commodity products exceed the established make allowances, the calculated classified prices will essentially overvalue raw milk as an input.

Cooperatives operate dairy manufacturing plants in nearly all Federal Orders. Many of NMPF's member cooperatives own and operate plants that manufacture commodity dairy products. To maximize plant throughput, cooperative organizations produce commodity-style products even though these products have a smaller margin than branded products. This approach of maximizing a plant's processing capacity

[3] See 64 Fed. Reg. 16,091 (evaluating alternatives to BFP based on "(a) stability and predictability; (b) simplicity, uniformity, and transparency; (c) sound economics—e.g., consistency with market conditions; and (d) reduced regulation.").
[4] 78 Fed. Reg. 9269 (Feb. 7, 2013).
[5] 64 Fed. Reg. 16,094-95 (Apr. 2, 1999).

is especially important in clearing the milk supply available to local markets and utilizing milk processing assets more fully.

Many of these manufacturing plants also balance milk supplies when Class I, II and III customers require more or less milk to meet their finished good demand needs. In this way, cooperative manufacturing plants balance the market by providing an outlet for milk not needed by their customers on a monthly, weekly, and even daily basis. Typically, balancing plants do not run at full capacity and are used as needed. This milk market balancing function implies running plants below full capacity which increases the operating costs per unit of commodity plants.

Cooperatives making commodity-style products operating under Federal Orders cannot recover a larger margin on their commodity products. If they raise their commodity product prices to capture a larger margin to cover higher costs, those higher prices go directly into the class prices and effectively eliminate the larger margin. In effect, the Federal Order make allowances are the fixed margins to commodity production at cooperative plants.

Margins on commodity products are very low, typically only a few cents per pound. Given the cost of new plant construction that can easily run into multiple hundreds of millions of dollars, the decision to build new capacity for commodity and balancing plant assets is difficult. Similarly, when existing plants see compressed margins a natural first response is to attempt to cut costs. Unfortunately, sometimes this comes in the form of underspending on needed maintenance. While this process of "bleeding the assets" can work for the short term, it eventually results in devalued assets and shorter asset life.

When make allowances undervalue actual manufacturing costs, producer pay prices and their respective milk price returns are not equivalent. Producers participating in markets in which their cooperatives process a large portion of the producer milk into Class III and Class IV commodity products are disadvantaged competitively when make allowances undervalue the cost of processing that milk.

In short, outdated, undervalued, inadequate make allowances compress margins at cooperatively owned commodity manufacturing plants and place an unfair burden on cooperative producer members compared to producers who are not members of milk processing cooperatives.

Make allowances that are set too low create a circumstance where dairy farmers who have not made investments in brick-and-mortar benefit from inflated class prices and the resulting inflated blend prices, while cooperative members who own manufacturing plants either must endure inadequate returns on their plant investments or receive reduced pay prices. Unequal farm prices for milk, given similar time and place, is a clear example of disorderly marketing. USDA has reiterated this tenet of equitable producer prices in earlier FMMO decisions.

> "This final decision does find that disorderly marketing conditions are present when producers do not receive uniform prices."

Federal Register / Vol. 71, No. 177 / Wednesday, September 13, 2006 / Proposed Rules 54145

> "The AMAA also authorizes the establishment of uniform prices to producers as a method to achieve stable marketing conditions. Market wide pooling has been adopted in all Federal orders because of its superior features of providing equity to both processors and producers, thereby helping to prevent disorderly marketing conditions. A market wide pool, using the

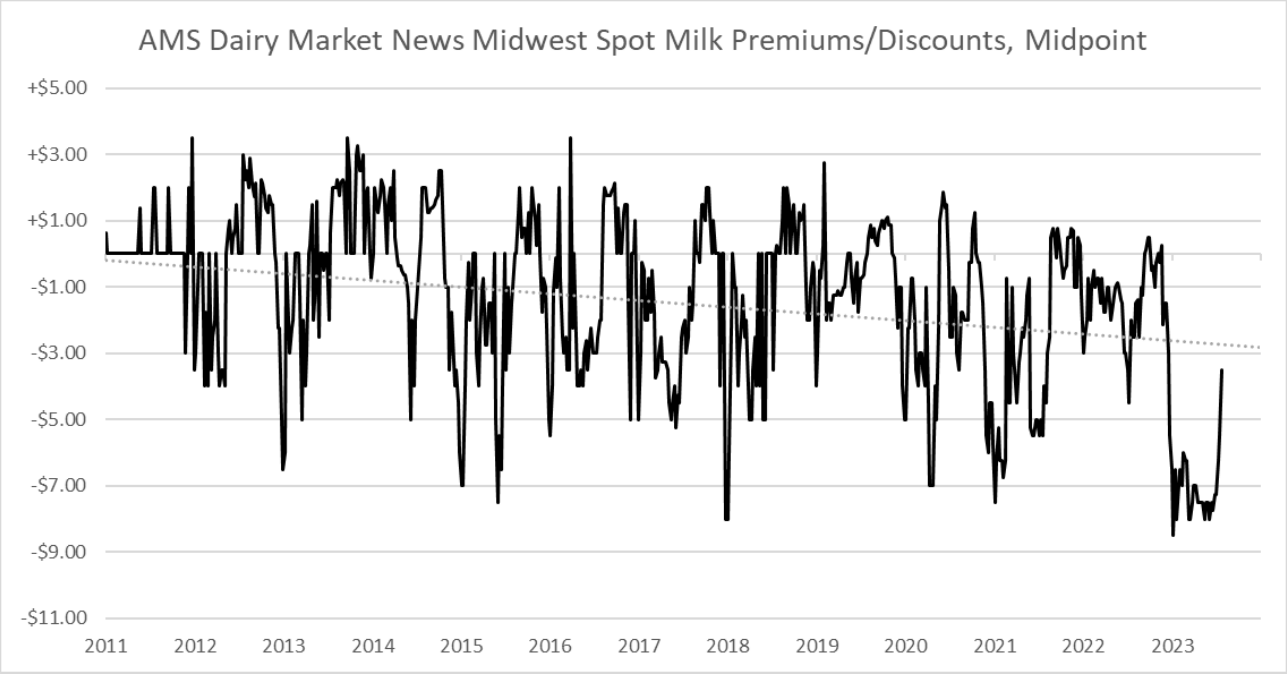
> mechanism of a producer settlement fund to equalize on the use-value of milk pooled on an order, meets that objective of the AMAA of ensuring uniform prices to producers supplying a market."

51652 Federal Register / Vol. 68, No. 166 / Wednesday, August 27, 2003 / Proposed Rules.

> "According to the tentative decision, certain inadequacies of the supply plant pooling provisions were resulting in disorderly marketing conditions and the unwarranted erosion of the blend price received by those producers who consistently provide milk to meet the fluid demands of the Central marketing area."

Federal Register / Vol. 68, No. 166 / Wednesday, August 27, 2003 / Proposed Rules 51641.

Cooperative members experience these impacts thru discounted milk prices going into their own plants to account for make allowances that are set too low, thus reducing current month milk checks or pricing the milk closer to or below class prices knowing there will be negative returns at their plants to be covered at the end of the financial year. Data from AMS shows the effect of both these discounts and the lack of investment in manufacturing plants to process and balance milk supplies. As make allowances have fallen further behind actual commodity make costs, spot milk premiums have trended lower.



These negative impacts absorbed by cooperative producers stem directly from make allowances that are set too low and are further exacerbated by the critical role that cooperatively owned manufacturing plants play in balancing milk supplies in FMMO markets. Cooperative manufacturing plants represent financial investments by their members. Cooperative members have paid to build and maintain their cooperatives' manufacturing plants and are responsible for the costs to operate them. When Federal Order make allowances are established at levels below the costs of producing commodity dairy products, farmers whose cooperatives own and operate balancing plants end up absorbing those costs

that other market participants do not experience. However, all producers benefit from the orderly marketing system enabled by cooperatives operating milk balancing plants within the market. As cooperatives pass the market wide balancing losses onto their members via reduced pay prices, producers shipping to handlers that do not operate balancing plants do not experience these lower pay prices. This unfairly penalizes dairy cooperative members who invest in plant and marketing systems to support orderly marketing.

3. The negative impact on milk producers of increasing make allowances must be considered by USDA

The outdated make allowances need to be revised to account for increases in costs to produce butter, nonfat dry milk, cheddar cheese and dry whey. USDA should consider the best plant processing cost data available when updating make allowances. However, given the length of time since the last make allowance update, making the sudden change to make allowances to fully reflect current manufacturing costs would be very disruptive to dairy producers and impose undue financial hardships on them.

The proposed increases in the four make allowances strike an appropriate balance between the impacts on processors and producers. We acknowledge that the proposed increases will lead to lower class prices and lower blend prices for producers. The initial increase to make allowances would have the following impacts:

- Reduction of $0.047 per pound of butterfat,
- Reduction of $0.042 per pound of nonfat solids,
- Reduction of $0.079 per pound of protein, and
- Reduction of $0.032 per pound of other solids.

Following through the class formulas, these decreases in component values would impact the class prices as follows:

- Reduction of Class III price by $0.58 per hundredweight,
- Reduction of Class II and IV price by $0.53 per hundredweight, and
- Reduction of Class I price by $0.50 per hundredweight.

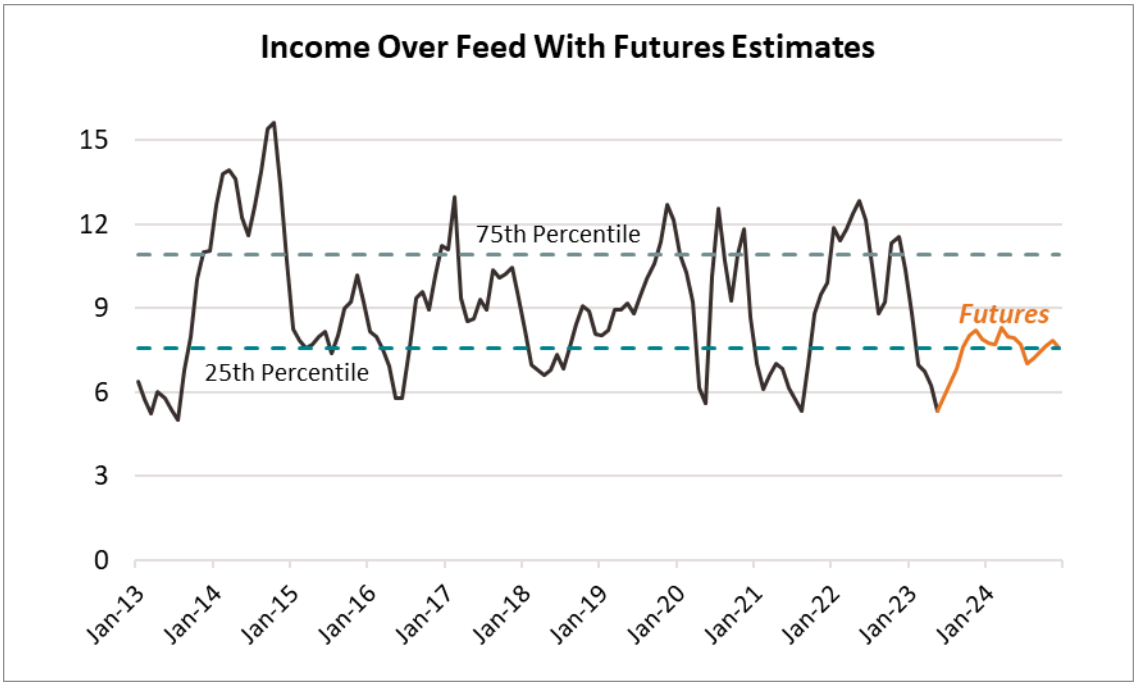
Assuming the implementation of the proposed increase in make allowances, dairy market supply and demand factors for milk and dairy products would likely mitigate some of the initial price impact on milk producers. Nonetheless, it cannot be overstated that the impact of increasing allowances will negatively impact producer milk prices and their margins will be compressed. Make allowance increases larger than those proposed by NMPF will have a larger negative impact on milk producer's margins and increase the likelihood of jeopardizing the milk supply going forward. The larger changes in make allowances proposed by the IDFA and the WCMA at the end of four years would narrow producer margins to levels that would significantly impact producer profitability and put the availability of adequate supplies of milk at risk, and, thereby, lead to disorderly marketing.

Producer margins have become significantly compressed in the first half of 2023 and may be more compressed in second half of 2023, perhaps into 2024. Class III and Class IV prices have averaged $5.47

and $6.08 per hundredweight lower thru June compared to 2022 and have translated into major decreases in FMMO uniform prices.

USDA projects the 2024 US All Milk price will drop to $19.10 per hundredweight. That represents a decrease of $6.24 from the 2022 All Milk price of $25.34 representing a decrease of nearly 25%. [USDA WASDE, July 2023] This drastic drop in milk price, without a similar decrease in other milk production costs, has narrowed margins on many dairy farms to the point of being below their cost of production.

Income over feed is shown in the chart below as a proxy for producer profitability. Historical data is from USDA Ag Prices reports, while corn, soybeans, Class III and Class IV futures are used to show estimates of profitability into 2024, which remain near the 25th percentile of the 10-year history of data.



4. The industry needs a mandatory, audited, survey of commodity manufacturing cost to provide data to use in discussions to propose updates to the make allowances.

Although the current Federal Order make allowances are overdue for updates, the data available to do so are not sufficiently comprehensive and unambiguous to establish revised make allowances confidently. Accuracy and specificity are required to make such changes because "the make allowances … should cover the costs of most of the processing plants that receive milk pooled under the orders."[6]. Also, because make allowances have not been altered for so many years, bringing them up to date in a single step would create disorderly market conditions due to the impact on regulated milk prices and on prices paid to and margins of dairy farmers. Land O'Lakes recommends that the make allowances be updated as follows:

[6] 65 Fed. Reg. 76,839 (Dec. 7, 2000) (emphasis added).

1. Provide an interim increase to alleviate the acute problems and disorderly market conditions created by the current, clearly insufficient make allowances.

2. Enact the authority for the Department to conduct mandatory, auditable plant processing cost studies, conduct such a study under that authority, and present the resulting data to the industry, which will enable interested parties to make requests for further make allowance adjustments based on proper and adequate data.

3. Continue to conduct and report plant processing cost studies regularly and systematically under the same legislative authority and mandate.

NMPF's proposal strikes a balance between several objectives. It is directionally correct, increasing make allowances from their current inadequate levels but, in the absence of definitive data, not increasing them so high as to be dependent on projections or on plant processing cost surveys that have been disputed.

Land O'Lakes agrees with the two-step approach recommended by NMPF. The proposed make allowances are necessary and sufficient for the near-term, but more importantly, once USDA has been given the authority to conduct a mandatory cost study, then the industry will have more definitive data to make necessary longer term make allowance modifications. Land O'Lakes believes a balance must be struck between the various industry stakeholders, and its recommended make allowance increases do so in an orderly, acceptable, and reasonable manner for the entire dairy industry.

Summary and Conclusions

Land O'Lakes recommends that the Department increase the make allowances as proposed by NMPF:

- an increase of $0.0385 per pound in the butter make allowance,
- an increase of $0.0422 per pound in the nonfat dry milk (NFDM) make allowance,
- an increase of $0.0397 per pound in the cheddar cheese make allowance, and
- an increase of $0.0309 per pound in the dry whey make allowance.

Land O'Lakes believes that the proposed make allowances are adequate, acceptable, and reasonable. These increases represent an interim step in aligning the make allowances more closely to actual manufacturing costs being experienced by processors of commodity dairy products.

Land O'Lakes manufactures these commodity products and has experienced a significant increase in manufacturing cost since 2006. This is corroborated by recent voluntary studies conducted by Dr. Mark Stephenson and analysis that updates the 2006 manufacturing costs using publicly available cost indexes. The effect of outdated make allowances that are set too low is to create disorderly marketing conditions, mainly in the form of:

- Lack of investment in manufacturing plants to process and balance milk supplies
- Inequitable pay prices to producers participating in the same market

It is clear that commodity manufacturing plants, especially those that are tasked with balancing milk supply and demand, struggle to make a profit since the effect of undervalued make allowances is to overvalue milk prices. This leads to a lack of investment in manufacturing capacity. At the same time, losses on existing plants are shouldered by producers that have made the decision to invest in

commodity processing assets, creating inequitable pay prices for those producers, which has been established in past decisions as a form of disorderly marketing. The costs of maintaining the market balancing facilities must be borne by the market, not only by the owners of the facilities.

However, the last make allowance updates were in 2008 using 2006 data, and the gap between those make allowances and various estimates of current commodity manufacturing costs are substantial. As a result, NMPF has proposed make allowances that strike a balance between a necessary update, and producer profitability that is obviously challenged in the current market landscape. The risk of not striking such a balance is jeopardizing milk supply and creating more disorderly marketing conditions.

Longer term, the industry needs a mandated, audited survey of commodity manufacturing costs to provide the best data for future updates to make allowances. This is the one request that is included in both NMPF and IDFA petitions, and supported by several other interested parties that submitted petitions as well.

Land O'Lakes thanks the Department for calling this hearing to consider the modernization of federal milk marketing orders (FMMOs).

Proposed Order Language:

Amend 7 C.F.R. § 1000.50(l), (m), (n), (o), and (q), applicable to all federal milk marketing orders, to provide:

§ 1000.50 Class prices, component prices, and advanced pricing factors.

* * * * *

(l) *Butterfat price*. The butterfat price per pound, rounded to the nearest one-hundredth cent, shall be the U.S. average NASS AA Butter survey price reported by the Department for the month, less ~~17.15~~ **21.00** cents, with the result multiplied by 1.211.

(m) *Nonfat solids price*. The nonfat solids price per pound, rounded to the nearest one-hundredth cent, shall be the U.S. average NASS nonfat dry milk survey price reported by the Department for the month, less ~~16.78~~ **21.00** cents and multiplying the result **with the result multiplied** by 0.99.

(n) *Protein price*. The protein price per pound, rounded to the nearest one-hundredth cent, shall be computed as follows:

* * * * *

(1) …

(2) Subtract ~~20.03~~ **24.00** cents from the price computed pursuant to paragraph (n)(1) of this section and multiply the result by 1.383;

(3) Add to the amount computed pursuant to paragraph (n)(2) of this section an amount computed as follows:

(i) Subtract ~~20.03~~ **24.00** cents from the price computed pursuant to paragraph (n)(1) of this section and multiply the result by 1.572; and

* * * * *

(o) *Other solids price*. The other solids price per pound, rounded to the nearest one-hundredth cent, shall be the U.S. average NASS dry whey survey price reported by the Department for the month minus ~~19.91~~ **23.00** cents, with the result multiplied by 1.03.

* * * * *

(q)(3) An advanced butterfat price per pound rounded to the nearest one-hundredth cent, shall be calculated by computing a weighted average of the 2 most recent U.S. average NASS AA Butter survey prices announced before the 24th day of the month, subtracting ~~17.15~~ **21.00** cents from this average, and multiplying the result by 1.211.