United States Department of Agriculture
Before The Secretary of Agriculture

In re: [Docket No. 23-J-0067; AMS-DA-23-0031]
Milk in the Northeast and Other Marketing Areas

Hearing beginning August 23, 2023

Testimony Presented By:

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Proposal 13. Restore the Original Federal Order Reform Class I Skim Milk Price Mover

Introduction

My name is Craig Alexander. My testimony today is provided on behalf of and in support of the National Milk Producers Federation (NMPF) Proposal 13 to restore the original Class I Skim Milk Mover enacted under Order Reform in all Federal Milk Marketing Orders (FMMOs). My testimony is provided on behalf of Upstate Niagara Cooperative, an NMPF member cooperative, that supports the NMPF package of proposals at this hearing.

Upstate Niagara Cooperative is headquartered in Lancaster, New York and is owned by around 250 farmers including conventional and organic farms. The Cooperative markets over 2.5 billion pounds of milk annually and operates 8 processing plants; seven in New York and one in Pennsylvania. Our processed products include fluid packaged milk, cultured products, concentrated milk and cream, nonfat dry milk, butter, and retorted beverages. These products are sold to food service, retail, and food service partners across the nation and in Puerto Rico. We also market milk to several other bulk milk customers located in Western and Central New York, Western Pennsylvania, and Ohio. We market milk within Federal Order 1 and 33 as well as unregulated and state-regulated areas in New York and Pennsylvania.

I grew up on a small dairy farm in central New York and attended the State University of New York at Albany and Cornell University where I received a Master of Science in Agriculture Economics with a focus on dairy markets. I have spent 40 years involved in a variety of professional capacities for Upstate Niagara Cooperative, Dairy Institute of California, Cornell University and O-AT-KA Milk Products Cooperative. I currently serve as the Senior Director of Planning and Regulatory Affairs for Upstate Niagara Cooperative. I have appeared in several State and Federal Milk Order hearings since the 1980s.

Background of the Current Class I Mover

Pricing of farm milk for fluid drinking purposes has been a focal point in the industry since the infancy of commercial milk processing and distribution to stores and consumers. An imbalance of market position between farmers with a perishable product and fluid milk processors with variable demand, saw the developing need to price milk differently for fluid needs versus milk used for manufacturing cheese, nonfat dry milk, butter, and other more storable products. While at first producer cooperatives attempted to recognize this difference by pricing milk by use, the inherent bargaining disadvantages dairy farmers had in marketing milk saw the breakdown of the early form of "classified pricing." This was especially true as surpluses developed, sales declined, and the economy fell into the depression of the 1930s. As a result, government action was necessitated and a variety of economic regulations both at the state and federal levels were implemented with some involving classified pricing mechanisms to stabilize producer returns.

The modern form of this economic regulation, now known as Federal Milk Marketing Orders (FMMO), was enacted in 1937 in the Agricultural Marketing Agreements Act (AMAA). It allowed for producers to propose and vote on regulations to set classified prices based on use and combine the proceeds such that producers supplying a market could equitably share the benefits of the higher value Class I fluid market but also share the burden of the lower value class or classes. Class I prices were set by a variety of means. In some markets economic formulas were used while, in others market clearing manufactured product price indexes plus some regulated fixed premium were used. At first markets were relatively small and isolated to areas around major cities. Over time, transporting milk supplies and distribution of finished fluid milk products became more feasible. The wider areas of competition between processors necessitated a more coordinated means to set Class I prices both over time and over geographic distance between different milk order areas. The Minnesota-Wisconsin monthly milk price survey of unregulated Grade B milk came to be used instead of economic formulas and indexes in the 1960s with Class I prices set using the previous month's survey price. This would essentially set the coming month's Class I price in advance. In this way Class I processors would know their costs in advance and be able to announce prices to customers. However, with being set monthly based on competitive pay prices – prices could move over time to represent milk values to producers. The supply and demand forces shaping milk markets could be reflected in a timely fashion. The M-W price was a single price which blended the value of Grade B milk used to manufacture butter, dry milk powder and cheese products. At the same time, Class I price "differentials" were added to the M-W mover to recognize Grade A production costs, servicing of fluid markets, and a geographic dispersion of location value recognizing transportation costs between and within market areas. This provided price signals between areas of reserve milk supply to areas with greater Class I fluid needs. Although not in lock step with the M-W each month, the higher Class I price and monthly movement provided a short time lag

and signaled incentives to supply Class I milk while allowing processors of Class I products advanced cost information. Thus, both the location value and the time value of price signals were combined with the valuation of milk through classified pricing and together were key components of the pricing system of Federal Order regulation.

While the M-W price mover worked well for several decades, during the 1990s it became apparent that a shrinking Grade B milk supply and reduced numbers of plants buying the milk was leading USDA to have less confidence in the survey's statistical basis. For a short time, a modified version of the M-W mover that was known as the Basic Formula Price or BFP was used. The BFP operated in a similar fashion moving Class I prices monthly based on survey results but suffered from the same declining Grade B milk volume.

In the FMMO Reform process, several alternative ways to set and move Class I prices were reviewed. USDA, with input from the industry, adopted a new system of setting class prices and consequently a new class I mover for all FMMOs. The new system adopted "end product" price formulas to determine minimum class prices. These manufacturing class prices were derived from monthly surveys of product prices of cheddar cheese, dry whey, butter, and nonfat dry milk minus the conversion costs (or "make allowances") and yield factors as established by USDA through the hearing process. The transition to these new class price formulas involved the uniform adoption of four classes of milk, including two basic manufacturing use classes, Class III and Class IV. USDA had to then decide on a replacement to the M-W/BFP to set and move Class I prices. In 1999, the Department determined the mover should be the "higher of" the Class III or IV prices as calculated using the first two weeks of the prior month's price survey data.

The 1999 Final Decision for FMMO Reform identifies at least four reasons for using the higher of Class III or Class IV as the mover (Higher of Mover) and base value for Class I skim milk prices. First, basing Class I on the higher of III and IV would "more accurately reflect the value of (milk in) these different categories of use" in a four class system. Furthermore, given the separation of manufacturing milk into two classes, using the higher of Class III and IV would "assure that shifts in demand for any one manufactured product will not lower . . . Class I prices." (64 Fed. Reg. at 16094, col. 2). Second, using the higher of the two classes "to move Class I prices [will help] to reduce the volatility in milk prices." (Id. at col. 3) Third, a major consideration was to address class price inversions and depooling. The decision (64 Fed. Reg. at 16102-03) stated:

> *Class price inversion occurs when a market's regulated price for milk used in manufacturing exceeds the Class I (fluid) milk price in a given month and causes serious competitive inequities among dairy farmers and regulated handlers. ... Thus, an inequitable situation has developed where milk for manufacturing is pooled only when associating it with a marketwide pool increases returns. Illustrative of the worsening class price inversion problem are the growing volumes of milk that, while normally associated with Federal milk orders, are not being pooled due to price inversion problems. ... Since volatility in the manufactured product markets is expected to continue, the Class I price mover developed as part of this Federal milk order reform process should address this disorderly marketing situation.*

The fourth and very important final reason was to help incent movement to Class I buyers and thereby assist Class I processors in the competition for available raw farm milk supplies. The decision stated:

> ***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. Use of the higher of the Class III or Class IV price will make it more difficult to draw milk away from Class I uses for manufacturing***. Id. at 16,103, col. 3. (**emphasis added**)

For all these reasons, it was concluded that the higher of the advanced Class III or Class IV skim milk value should be the mover for Class I prices.

The Higher of Mover fit within the precedents and norms of historical use of how Class I prices relate across different FMMOs, over periods of time, and between other class prices since the early 60s under the M-W mover formula. This use of the Higher of Mover for pricing Class I Skim milk prevailed in all orders in the federal order system until the 2018 Farm Bill legislation.

Legislative Change to the Average of Class I Price Mover

Section 1403 of the Agriculture Improvement Act of 2018, which was implemented in the 2019 Final Rule, changed the Class I mover to the current language, which uses the "Average of Mover" of the advanced Class III skim factor and the advanced Class IV skim factor price plus a fixed differential of $0.74 per hundredweight. This legislated change in the mover was requested by a segment of Class I processors to allow them the ability to hedge the cost of Class I milk in the dairy product futures markets. It was a clear departure with the historical use of how Class I prices had related to manufacturing milk prices and were moved since the 1960s. NMPF acceded to this request, subject to adding a $0.74 per hundredweight fixed differential. This $0.74/cwt. was based upon the long-term average value that the Higher of Mover contributed to the Class I price as compared to the Average of Mover approach from January 2000 through August 2017. It was the intention of both Class I milk buyers and dairy farmer sellers that the change would be revenue neutral over the long term and would accommodate certain buyers' interest in using available price risk management tools.

However, due to the Congressional mandate, the USDA could not apply the four criteria as originally adopted when choosing the Higher of Mover as clearly articulated in the 1999 Final Decision on Federal Order Reform. Unfortunately, unintended consequences resulted as the 2019 amendment has not operated as intended or anticipated by NMPF or its producers. It has instead exacerbated disorderly marketing conditions, and negatively impacted producer revenue. These serious and negative outcomes will continue so long as the Average of Class I Mover remains in place.

Disorderly Conditions Caused by the Average of Mover of Class I Prices

The following problems were revealed by the change to the Average of Mover and resulted in an erosion of producer confidence in the operation of the FMMO system as a consequence:

1) Pricing of Class I milk was significantly reduced without recovery for producers in other class prices. Producers with higher Class I utilization were most severely impacted.
2) Due to increased price discrepancies and price inversions, depooling increased with inequitable impacts for handlers and producers – especially those who do not have an option to de-pool while others can avoid the pool when price inversions occur.
3) Class I prices meant to incent movement of milk to fluid processors relative to manufacturing prices were disrupted more of the time under the Average of Mover than occurred with Higher of Mover pricing.
4) The pricing discrepancies were not a one-time anomaly and in fact have caused and will continue to cause problems for orderly markets in the future if not remedied and put back to a Higher of Mover pricing.

Negative Producer Prices and Income Impacts

The Average of Mover plus $0.74 per hundredweight, which has been in operation since May 2019, has resulted in a clear reduction to Class I prices compared to the Higher of Mover had it in been in place. As detailed in Dr. Peter Vitaliano's testimony, the new mover created increased and uneven or "asymmetric" price risk for dairy producers as compared to Class I buyers of milk. As previously stated by Dr. Vitaliano, mathematically, the Higher of Class I mover will exceed the Average of plus $0.74 per hundredweight Class I mover whenever the Class III and IV advanced skim milk pricing factors differ by more than $1.48 per hundredweight. This will happen regardless of which of the advanced skim pricing factors is higher. The maximum amount by which the Average of Mover plus $0.74 Class I mover can exceed the Higher of Class I Mover is $0.74 per hundredweight, which occurs when the two advanced skim milk pricing factors are equal. Importantly there is no limit to how much the Average of Mover can fall below the Higher of Mover.

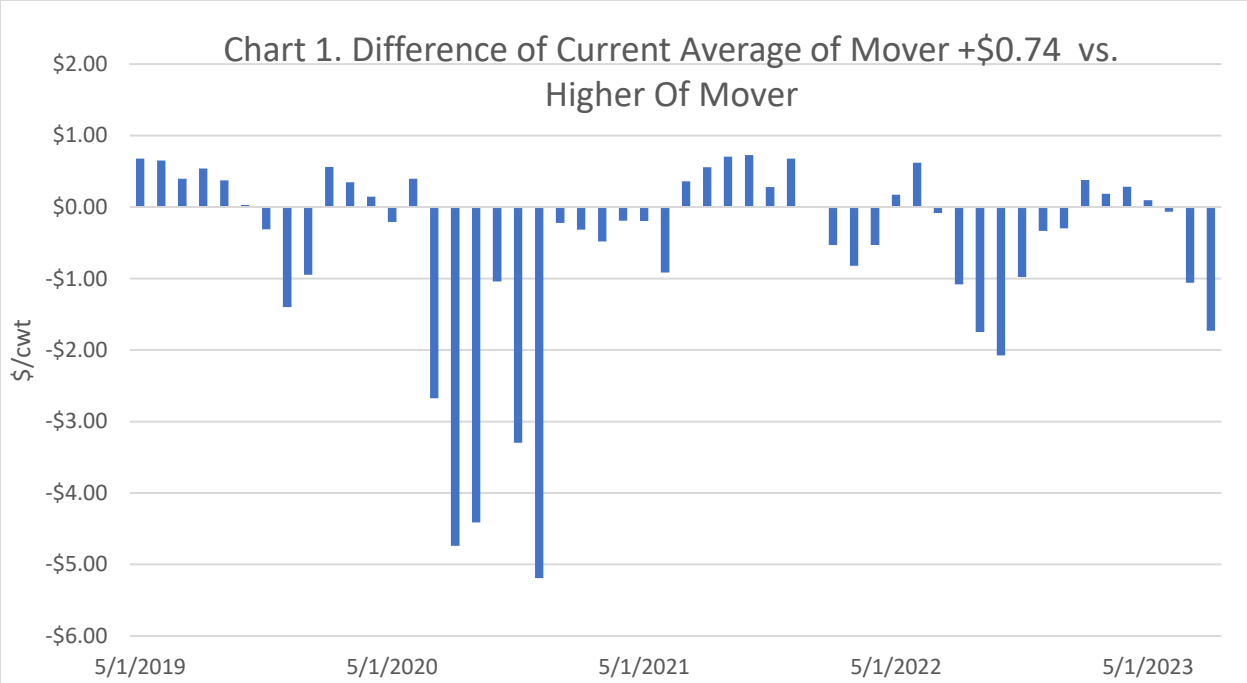

Chart 1 above shows the monthly difference between the Average of Mover plus $0.74 and the Higher of Class I mover per hundredweight of milk. This difference was calculated using announced prices by

USDA and calculated prices as would have been calculated under the Higher of Mover. Producers painfully saw the shortfall in milk checks using the Average of Mover during 2020 with the large spread in prices between manufacturing classes. Class I skim milk prices under the Average of Mover deviated by over $5.00/cwt. in December 2020. Obviously, this asymmetric price risk of the current Average of Mover became particularly acute during the Covid impacted markets driven by government policies stimulating cheese consumption. However, negative impact on producers happened again throughout much of 2022 and 2023. This suggests that this is not a one-off pandemic era issue. During 2022 and 2023, however, Class IV prices well exceeded Class III. When Class III and IV spreads widen, the Average of Mover performs poorly compared to the Higher Of Mover. Chart 1 also clearly demonstrates that the amounts by which the Average of Mover exceeded the Higher of Mover was always by no more than $0.74/cwt, however negative values greatly exceeded $0.74/cwt during several months since implementation.

NMPF Exhibit 30A details the calculation of losses by month and by Federal Order since the legislated Average of Mover became effective in May 2019. The combined market losses on pooled Class I skim milk values in all orders has reached $941.1 million through July 2023. In the Northeast, FMMO producers lost $178.4 million during that time. The largest loss across all FMMOs occurred in December 2020. Another witness will discuss the serious impact on the Southeast market where producers suffered larger per hundredweight negative returns as a result of the current Average of Mover as the region has higher Class I utilization and strong demand for milk. More recently, in 2022 and early 2023, we can see that there were significant losses in 12 of the 19 months since January 2022 resulting in a net loss of $264.9 million.

The NMPF appreciated and supported Secretary Vilsack's partial compensation of these losses through the Pandemic Market Volatility Assistance Program. However, as stated by Dr. Vitaliano, this would not have been needed if the change to the Class I mover had not been made. Even more importantly, producers cannot rely on USDA, Congress, or taxpayers to always make up the difference due to pricing disparities caused by the Average of Mover. This type of policy also does not make up for the loss of timely market signals needed during periods of strong demand and/or tight supply.

Negative Impacts from Increased Depooling

Depooling of producer milk typically can happen where manufacturing class prices rise above the pooled returns generated by the different classes of use in a market pool. As described previously, this is not an efficient or equitable condition and USDA sought to reduce this disorderly result as a rationale for use of the Higher of mover during Order Reform. The "in and out" of depooling milk was something that USDA tried to mitigate through regulation of Class I price levels and relationships with other class prices. For example, USDA expressly chose to reduce the time lag in pricing information by using the 2-week advance Class III and IV movers in Federal Order Reform to help limit price inversions (i.e., Class I prices being below one or more other classes) and thereby reduce incentives to depool milk.

The change to the Average of Mover significantly increased the level of disorderly marketing because Class I prices were lower relative to one of the other manufacturing classes. This created greater incentives to depool milk. This ultimately led to lower uniform prices for pooled milk and this situation has reoccurred more frequently since the legislated change to the Class I mover was made. This reality confirms the 1999 Final Decision justification that the Higher of Mover would "assure that shifts in demand for any one manufactured product will not lower . . . Class I prices." To reiterate and provide an example, the enhanced demand for cheese generated by the Farmers to Families Food Box Program.

The Program's significant purchases of cheese for food assistance, relative to the demand for butter and nonfat dry milk, led to comparatively lower Class I prices. These class price inversions resulted in substantial depooling of Class III milk and disorderly marketing conditions during the second half of 2020. Other proponent witnesses will provide further information and discussion around the increased problem of depooling caused by the Average of Mover.

However, the problems of 2020 are not a one-time phenomenon. Class price inversions recurred in 2022 and 2023. This time, it featured higher Class II and Class IV milk prices compared to uniform market or "blend" prices. The result was substantial depooling of Class II and IV milk, while other milk was required to remain in the pool and disproportionately absorbed the impact of price inversion. As an example, Table 1 shows Federal Order 33 (USDA Exhibit 44) pooled milk in Class II and Class IV during October 2021 and October 2022. The October 2022 Class II and Class IV prices were $25.73/cwt and $24.96/cwt, respectively. With the lower announced Uniform price of just $21.81 per hundredweight, there were incentives to depool milk. The announced Class I price was $24.71/cwt with the Average of Mover and would have been $26.79 under the Higher Of Mover, $2.08 higher, and higher than both Class II and Class IV prices.

Table 1. FO 33 Pooled Class II & IV Pounds October 2021 & October 2022.

	October 2021	October 2022
Class II Pounds (million pounds)	317.1	114.5
Class IV Pounds (million pounds)	166.2	14.6
Source: USDA Exhibit 44		

Pooling is a complicated phenomenon impacted by more than just one factor. However, a change in pricing which contributes to a lower relative Class I price to manufacturing prices such as we have seen can't help but reduce incentives to pool. The use of the Average of Mover results in more depooling and increased potential for different price returns to producers within in a market area. Ultimately, this undermines the FMMO goal of uniform returns to producers. With the potential for greater discrepancies between producers and less milk pooled, there will also be reduced incentives to supply Class I milk and increased potential for differences of raw milk costs to processors of like dairy products. Should the Average of Mover continue to be used, it will be destructive to efficient operation of milk markets over the long run as production, processing and milk movement incentives will adjust accordingly.

Negative Impacts to Timing of Milk Price Signals to Processors and Producers

The generally higher prices for Class I milk act as a real time signal from Class I processors to producers to draw more milk when needed to Class I use versus manufacturing uses and encourages farmers to produce more milk when needed. Under the Higher of Mover, as there was with the M-W/BFP mover, there is a short delay (although the Higher of Mover is actually about 18 days shorter than the M-W/BFP) of market prices being transmitted to producers. This does sometimes result in a variance or inversions as to how Class I prices relate to manufacturing prices. Typically, these inversions resolve quickly as markets regain equilibrium. However, the change to the Average of Mover exacerbates delays in price transmission to an even larger magnitude. Months can go by where the prices not only do not catch up but, in fact, never get caught up due the maximum upside value being no greater than $0.74/cwt for producers. Using an averaging concept disconnects the Class I price from the competitive manufacturing prices and there is no recovery of lost income for producers. This disconnect further

disrupts the price signals by disincentivizing the movement of milk to Class I outlets when other options exist (as well as depooling – already discussed). Additionally, the larger and longer variance in the market signals reduces the incentive for farmers to produce and supply milk when the market needs it. Both characteristics of disrupted prices signals are at odds with the purposes of the AMAA and FMMOs. The AMAA speaks directly to correcting such problems inherent in fluid milk markets prone to disorderly marketing problems, not exacerbating them. Our witnesses, both producers and cooperative representatives, have or will further enumerate with additional testimony the significant costs and disruption to them.

Negative Impacts Are Likely to Reoccur

The current Class I mover does not operate as intended because it builds in an unintended asymmetric risk to producer income, resulting in millions of dollars in losses of producer income. As we have seen, price volatility and periodic significant Class III and IV price discrepancies have been a basic feature of dairy markets in the recent past. Since 2000, I calculated that the difference in Class III and IV prices have exceeded $1.48 (the level where current Class I prices are capped at the Average of Mover plus $.74 as compared the Higher of Mover), 106 months out of a total 282 months between 2000 and June 2023 or **39.6%** of the time using data from USDA Exhibit 15.

It has more often been the case that Class III prices exceed Class IV by the wider margin. However, not always. In fact, in 42 of the 106 instances or **37.6%** of the time it has been Class IV that has exceeded Class III – this is not insignificant. In 2022, in 9 of 12 months Class IV exceeded Class III by more than $1.48. The July 2023 advanced Class IV skim milk pricing factor was $3.61/cwt higher than the advanced Class III skim milk pricing factor – well above the point where producers see any benefit from the Average of Mover. There is no reason to believe that these types of discrepancies will not continue in the future, featuring all of the unintended problems we have described.

The Benefits of the Average of Mover are not Worth the Costs to Dairy Markets

The change by Congress may have been well-intentioned and neither processor nor producer groups anticipated the problems created. The goal of facilitating more use of existing hedging tools by some Class I processors was an idea that, at the time, seemed to have merit with minimal impacts to markets and producers. Obviously, we have seen otherwise.

In fact, the demand for hedging of Class I sales is less than clear. In our own case, our cooperative has four Class I plants and supply a variety of Class I customers which includes retailers, food service distributors and institutions such as schools and hospitals. From the interactions we have with our customers, there has been widespread acceptance of moving prices based on Federal Order price announcements by our conventional fluid customers across our different distribution channels. It's been shared with me that conventional customers have been less interested in pursuing a fixed price if there was any chance that they would be uncompetitive in the marketplace in any given month. Customers have also been reluctant to pursue risk management/fixed pricing unless it comes at no additional cost to them.

Regardless of the amount hedging occurring in the Class I market, we would question the disruption of market signals and cost to producers by use of the Average of Mover. We recognize that there may be some processors or end users in specialized Class I product channels that may utilize hedging, however, we would contend that it is a relatively small slice of total Class I sales. By way of illustration, if we

assume that this segment represents 15% of total Class I sales, and Class I sales on a national basis are about 30%, the percentage of milk that may be interested in hedging would at most calculate out to be about 4.5% of all pooled milk. Obviously, some markets have more and some less than the 30% Class I example used, however the point remains valid. It is likely a relatively small factor in the overall fluid milk market. While we appreciate that there has been growth in specialized fluid products, it is our contention that milk sales of some of these products were strongly trending up prior to implementation of the Average of Mover. This was due to changing consumer preferences and the ability of some processors to respond to that demand with innovative products. As such, if the Higher of Mover is restored, as we recommend, consumer preferences will drive sales, not the change of Class I mover.

The question we have is whether the cost of disorderly marketing and negative producer returns is worth the benefits it may provide to a small segment of the dairy market? We have discussed how the Average of Mover was a significant departure with decades of precedent adopted by USDA and approved by the producer community regarding the movement of Class I prices relative to other class prices since the early 1960s. We believe the answer is clear. The cost is too high and disorderly market conditions too great to maintain the current Average of Mover formula.

We will have other witnesses with experience in processing and selling Class I products that will testify to their knowledge and experience regarding the amount of hedging within the Class I fluid product category. The expert industry witness that follows me will discuss the specific efficacy of hedging Class I milk and associated issues under different pricing systems.

The 2018 Legislation Authorized Future Changes through Hearings

The 2018 legislation passed by Congress changed the Class I mover but also allowed for hearings to amend the Class I formula after 2 years. Taking from the legislative language:

> *Throughout the 2-year period beginning on the effective date of this sentence (and subsequent to such 2-year period unless modified by amendment to the order involved), -* Section 1403 of the Agriculture Improvement Act of 2018

The language provided by Congress established this trial 2-year period and in effect returned future pricing authority to producers and to the judgement of the Secretary of Agriculture. This is important as problems did indeed occur and wisely Congress allowed for changes to be subsequently made through the normal FMMO hearing process. We are here today to support the reversal of this change and recommend that the Secretary use this authorizing language to respond to problems, albeit unintended, that the Average of Mover created.

Restoring the original Higher of Class I Skim Milk Price Mover

For all of the foregoing reasons, the National Milk Producers Federation supports the return to the Higher of mover formula and maintaining current advanced pricing. Reverting back to the Higher of Mover will restore more orderly marketing and producer confidence in the FMMOs by:

1) Eliminating the asymmetric risk to producer prices and income that was devastating to milk producers under the Average of Mover.
2) Enhancing market signals to producers. With Class I milk being based on the higher manufacturing class, it will improve the timeliness for returning value to farmers closer to when the market is signaling needing milk supplies. The Higher Of mover will create better alignment and incent milk to move to Class I use to assure milk is being supplied.
3) Reduce incentives to engage in depooling practices which undercuts the ability to equitably provide returns to producers which is a central tenant of Federal orders
4) Restore the historical concepts of price movement and relationship of Class I prices to other class prices which have long been supported by producers and USDA.

In summary, we support the proposal and language as drafted by NMPF in the hearing petition. The 'Higher of Mover' proposal is widely and enthusiastically supported by the producer community. Others testifying at the hearing including producers and cooperative representatives will discuss the issues of: revenue impacts at the farm level, depooling, attracting Class I supplies, and a concern that problems will continue if left unaddressed. They will also discuss the questionable cost benefit of upending decades of experience with price regulation for a small segment of the dairy industry, and the failure to find an acceptable alternative to the Higher of Class I mover.

On behalf of Upstate Niagara Cooperative and the National Milk Producers Federation, we appreciate the opportunity to testify today and ask for the consideration of our proposal to return to the Higher of Mover for calculating the Class I Skim Milk Mover and we thank USDA and Secretary Vilsack for holding this important hearing.