Testimony of
Michael McCully
On behalf of
Kraft Foods
At the
Federal Order Class I and II Price Formula Hearing

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My name is Mike McCully, Associate Director of Dairy Procurement at Kraft Foods, and I am testifying on their behalf. I have worked for Kraft over 10 years and currently have responsibility for U.S. milk procurement, U.S. and global dairy market analysis and price forecasting, and U.S. dairy commodity risk management. Kraft is a member of the National Cheese Institute, Milk Industry Foundation, and the International Dairy Foods Association. My testimony is in opposition to National Milk Producer Federation's (NMPF) proposal to amend the Class I and Class II milk formulas, and also opposes the need for an emergency ruling.

Kraft is a major manufacturer and marketer of cottage cheese and sour cream with leading brand names of *Breakstone's* and *Knudsen*, along with other Class II products, such as *Polly-O* Ricotta Cheese. Kraft's production facilities are located in Walton, NY for cottage cheese and sour cream, Visalia, CA for cottage cheese and sour cream, Campbell, NY for ricotta cheese, and Lehigh, PA for Tassimo coffee products. We also buy cottage cheese products made by CoolBrands at the former Kraft plant in North Lawrence, NY.

History has a way of repeating itself, and dairy policy is no exception. Take the case of Baldwin v. G.A.F. Seelig (294, U.S. 511, 523). It stated that

Exhibit 3e
Witness
Date Rptr.
Powers Garrison & Hughes

milk prices needed to be artificially enhanced for the "maintenance of a regular and adequate supply of pure and wholesome milk; the supply being put in jeopardy when farmers... are unable to earn a living income." While this sounds like it was taken from today's headlines, it is in fact from 1935. And since the United States has not run out of milk since that time, one can conclude similar comments currently, while retaining political and popular appeal, are not reflective of actual supply conditions. More recently, Dairy Farmers of America (formerly Mid America Dairymen and others) proposed implementing a price floor of $13.50/cwt on Class I and II milk at an early 1998 hearing. While the approach was different from the current NMPF proposal, in effect, it would have also decoupled Class I and II prices from Class III and IV prices. USDA denied their proposal and the rest of 1998 saw record high milk and dairy commodity prices.

If Kraft were acting in its own self-interest, we could actually support this proposal from NMPF. USDA's own analysis for this hearing has shown the increase in Class I and II prices would reduce Class I usage and force more milk into manufactured uses. As a result, following basic economic supply and demand logic, dairy commodity prices would decrease benefiting cheese companies like Kraft. However, Kraft opposes NMPF's proposal for the following reasons:

- It would have a negative impact on Class II products
- It would result in benefits that are regionally disproportionate
- It is the wrong solution to a longer-term problem

- Emergency marketing conditions do not exist

Negative Impact on Class II Products

NMPF's proposal would have a direct and negative impact to Kraft's Class II products, as well as to the entire Class II product category. Since Kraft's products sell for a premium in the marketplace, we have limited ability to pass on higher costs. However, private label products are more responsive to cost changes. We analyzed nearly seven years of data to determine the correlation between Class II milk prices and retail prices for private label sour cream and cottage cheese. The correlations are positive and most apparent on a two-three month lag which is expected given how private label pricing works. Proponents state the cost increases resulting from this proposal can simply be passed on through retail pricing of these products. However, there is no consideration given to the impact on consumer demand from those changes. Prior testimony on this subject, as well as economic literature, has repeatedly documented the fact that consumer demand for manufactured dairy products is quite sensitive to changes in price. Without getting into a lengthy discussion over what the correct price elasticity is, one thing is clear: passing increased costs on to consumers will negatively impact demand for those products and the dairy industry at large.

Kraft works every day to increase demand for dairy products. Unfortunately, the demand trends for most dairy products have been declining over the past 20 to 30 years. Per capita consumption of cottage cheese declined from the mid-1970's to the mid-1990's before stabilizing at current levels. Kraft and other cottage cheese manufacturers have worked hard to stop this decline

by introducing innovative, new products, such as *Breakstone's* and *Knudsen Cottage Doubles*, and promoting the health benefits of the product. Per capita consumption of ricotta cheese increased steadily from the mid-1970's to about 2000 before falling slightly in the past five years. It is important to note that this trend change was concurrent with the last increase in the Class II minimum price, when the Class II differential was increased from 30 cents to 70 cents. If the goal for the industry is to increase consumer demand, increasing prices will not help to accomplish that goal.

NMPF's proposal would create disparities between products made in CA and the Federal Orders. Kraft has the ability to manufacture *Breakstone's* Cottage Cheese products in both NY and CA. In July 2006 following the temporary closure of our Walton, NY plant due to flooding, we shifted production of *Breakstone's* Cottage Cheese products to our plant in Visalia, CA. Normally, the Visalia plant produces *Knudsen* products for the West coast, but it also has the ability to produce *Breakstone's* products that are sold in the Midwest and East. Currently, it does not make financial sense to make *Breakstone's* products in CA. However, increasing the price spread between CA and Federal Orders has the potential to create shifts in product production out of the Federal Orders and into CA.

NMPF's proposal also would create disparities between dairy products and non-dairy products. As detailed earlier, if this proposal is implemented, prices for Class II products will increase. As an example, for a product like a dairy-based dip, companies could consider reformulating the product to use more

non-dairy products. Consumers would also potentially respond by shifting to non-dairy products, such as vegetable-based dips. Again, this does not help build demand for dairy products.

NMPF's proposal would create disparities between Class II milk and Class IV milk powders. While the current proposal to change the Class II skim price formula may appear to have an impact of less than a penny per hundredweight, it is the future that is of greater concern. In the past, changes in the Class IV price formula (Class III prior to order reform) automatically changed the Class II price formula; under this proposal, this link would be severed, and future changes in the Class IV price formula would automatically change the relationship between the Class II and IV skim prices. The question of the appropriate price relationship among the different classes was addressed at the May 2000 Federal Order hearing. In the final decision from October 2001, USDA found that "any reevaluation of the formulas used to price the components used in manufacturing products should be carried through to the class prices that are based on those component prices." The full summary provides additional context for the decision.

> "Neither the price relationships established in the final decision between milk used in Class III or Class IV and milk used in Classes I and II should be changed. To the extent that there may be differences in the Class III and Class IV prices between the current prices and those adopted in this decision as a result of adjustments to the component pricing formulas, those changes should be reflected in the Class I and Class II prices. Any reevaluation of the formulas used to price the components used in manufacturing products should be carried through to the class prices that are based on those component prices. A change in the computation of the nonfat solids prices, for instance, is intended to better reflect the value of those solids in dry milk products. If the

> new nonfat solids price formula results in an increase in the Class IV price, the record provides no basis for changing the difference in the value of milk used in those solids between Class IV and Class II use. Similarly, the availability of milk for use in Class I is related to the higher of the alternative manufacturing values for that milk. The current relationships should be maintained." Federal Register, Vol. 66, No. 207, Thursday, October 25, 2001

To be consistent with USDA's decision from the May 2000 hearing, NMPF's proposal should be denied.

Finally, USDA's own analysis of the impact on the Class II market shows this is a lose-lose proposition for everyone involved. As published in the notice for this hearing, the model used to analyze the impacts of this proposal provided the following results:

- Class II milk usage decreases by 20 million pounds
- Federal Order Class II receipts increase by $12 million, but it is not enough to offset decreases in cash receipts for other classes
- Total Federal Order class receipts fall by $8 million
- The all-milk price decreases by $0.01/cwt and average U.S. producer revenue decreases by $21 million

To summarize, the cost to manufacturers and consumers increases, demand decreases, and the price to farmers decreases. In short, this proposal seems to have the potential for significant negative impact without any benefit.

<u>The Benefits are Regionally Disproportionate</u>

Class I and II utilization varies widely by region. High Class I utilization markets include the Florida, Appalachian, and Southeast orders. Low Class I utilization markets include the Upper Midwest, Pacific Northwest, and Central

orders. The average for January through October 2006 is a 37% Class I utilization for all Federal Orders. For Class II utilization, the Federal Order total is less than 13% in 2006. Once again, the Upper Midwest has the lowest usage with 5.5% for the January through October 2006 period, while the Northeast has the highest utilization of nearly 20%. Given the differences in utilization by order, it is clear NMPF's proposal would benefit producers in higher Class I and II utilization markets. Unfortunately, these same benefits do not accrue to producers in lower Class I and II utilization markets, specifically the Upper Midwest.

As a major buyer of cheese in WI, MN, SD, and IA, we are very concerned over the long-term impacts to the dairy industry in the Upper Midwest from this proposal. USDA's own analysis has shown the negative impact on manufactured products and Class III and IV prices. In areas with low Class I and II utilization, this proposal would decrease the milk prices for farmers in those areas. At the same time, it would increase prices for producers in the higher price markets in the U.S. such as the Southeast, and do very little for, or harm, producers in the lower price markets such as the Upper Midwest. In the Federal Register notice for this hearing (Volume 71, Number 225), USDA states "the proposed increases to Class I and II movers have the same effect as increasing Class I and II differentials at all locations by the effective proposed changes." I believe most of us remember the contentious and regionally divisive debate that took place in the late 1990's regarding Class I differentials. Unfortunately, NMPF's proposal has revived that debate.

The Wrong Solution to a Longer-Term Problem

NMPF's proposal states current Class I and II prices are inadequate to ensure orderly marketing and notes the growing difficulty of supplying deficit markets. We question whether this is a national issue or a local or regional issue. Since Kraft has not had any problem getting milk for our Class II plants in NY, PA, or CA, it appears that this is not a national problem.

If the problem is supplying deficit markets such as the Southeast, then specific policy, market, and technological solutions should be pursued. For example, location differentials in specific Southeast markets could be adjusted or increased. Instead of a policy change, market driven over-order premiums could be increased to promote more local milk production. Another example is concentrated milk could be shipped in from other areas where milk is more plentiful, such as the Upper Midwest or New Mexico/West Texas. Oranges aren't grown in Wisconsin or New Mexico, but consumers there seem to enjoy concentrated orange juice shipped in from Florida. With today's technology, concentrated milk could be utilized to fulfill the needs of those deficit markets, potentially at a lower cost for the entire system. Looking at new technology, just recently, researchers at Oregon State University developed a process to extend the shelf life of milk. Hydrostatic pressure processing produces a product with a 45-day shelf life when refrigerated and maintains the taste of fresh milk. These are just two examples of how technology has the ability to solve the problem of supplying milk to deficit areas.

The problem with milk supplies in the Southeast is not new. At the February 1998 BFP Price Floor hearing, Dr. Bob Cropp from the University of Wisconsin concisely explained the milk supply situation in the Southeast.

"Increasing Class I and II prices will not solve the seasonal Class I deficit of locally produced Grade A milk supplies in the southeastern markets. The southeast will always have a seasonal deficit of Grade A milk for Class I needs because of climatic conditions. The hot and humid weather places a lot of stress on milk cows. As a result, during the summer and early fall months, milk per cow declines and getting the cows bred back for more even yearly milk flow is not possible. With modern milk packaging, processing and transportation technologies, high quality milk in both bulk and package form can move economically long distances. Recognition and use of these technologies would result in a more efficient and economical dairy industry and would better resolve the shortages of local grade A milk supplies for Class I needs in the southeast. Increasing Class I and Class II prices will not solve the problem. Further, if producers in the southeast do respond to higher milk prices as expected, the southeast would experience an increased problem of disposing of *seasonal grade A milk surpluses* that now occur during some of the winter and spring months. For example, Florida during this time of the year, has more grade A milk than it can use for Class I and Class II uses and is sending loads of surplus grade A milk as far north as Wisconsin to find a manufacturing home."

Nine years later, it's still hot in the south in the summer, milk production continues to decline during this time, and milk is still transported into the region from distant places. Dr. Cropp noted several solutions to this problem and they remain valid today. Instead of implementing NMPF's proposal for a short-term fix, the entire dairy industry would be better served by implementing a long-term solution to a long-term problem.

One of NMPF's reasons for proposing to increase Class I prices is the increased cost of maintaining Grade A status for dairy farms. First, a historical review of this subject reveals this proposal is unnecessary. The United States Public Health Service/Food and Drug Administration (USPHS/FDA) has been providing guidance on milk safety since 1924, with the first *Grade 'A' Pasteurized*

Milk Ordinance published in 1965. It was about this time when the dairy industry was undertaking a significant upgrade in sanitation and milk safety at every point of the supply chain. At that time period, a significant investment was required to upgrade a dairy farm's infrastructure to meet these standards, so Grade 'A' milk commanded a premium in the marketplace. This premium was partially incorporated into the Class I differential, and it provided a financial incentive for farms to convert from Grade 'B' to Grade 'A' status. By 1973, only about 15% of farms were considered Grade 'B,' and that number continued to decline over time to less than 5% by the late 1990's and has remained at 2 percent since 1999. Therefore, while a premium for Grade 'A' milk was necessary 30-40 years ago, it is not relevant today.

Many of you will remember the M-W price, which was the average price of Grade 'B' milk in Minnesota and Wisconsin for manufacturing purposes. The Basic Formula Price (BFP) replaced this series in May 1995 because the pricing of Grade 'B' milk was no longer representative of the overall market place. Today, Kraft does receive a small amount of Grade 'B' milk at our Beaver Dam, WI facility. However, there is no difference in the price we pay for Grade 'B' milk compared to Grade 'A' milk, and in fact, is commingled on the same truck.

The Grade 'B' milk issue is just one of many structural changes that have taken place in the dairy industry over the past several decades. These macro structural trends will continue into the future regardless of micro changes to dairy policy and pricing. From a supply standpoint, milk production is migrating to the most efficient, lowest cost areas in the country. This phenomenon also occurs in

the production of many products such as corn, soybeans, vegetables, televisions, and computer chips.

Another macro trend in dairy is the long-term decline in per capita milk consumption for the past 30 years, and increasing milk prices will not reverse that trend. Dairy farmers contribute $0.15/cwt each month to the National Dairy Promotion and Research Board that gives most of the money to Dairy Management Inc. to promote dairy products. NMPF's proposal to increase Class I prices is inconsistent with this effort. Asides from some high-end luxury goods, it is difficult to find an example of where increasing a product's price leads to increased demand for that product. For most food and beverage products, higher prices lead to lower demand.

NMPF's proposal seems to also conflict with their own program, CWT or Cooperatives Working Together. Each month, the CWT program collects $0.10/cwt from participating farmers and cooperatives. The money is then used to either "retire" herds, or as an incentive to dairy manufacturers to export excess manufactured dairy products. In either case, the goal is to reduce the supply of milk available to the market. If NMPF believes there is inadequate farm milk for the Class I and II markets in the U.S. today, their proposal seems to be inconsistent with the goal of the CWT program. It is noteworthy that there are regional safeguards in place for the herd retirements. According to the CWT website (http://www.cwt.coop/cwt_faq.html), "limits are tightest in the East, South, and Midwest, and more lenient in the West and Southwest, where production is expanding fastest." With that mechanism, NMPF and the CWT program are

attempting to align supply and demand on a regional, not national, basis. The export program attempts to deal with "gluts of manufactured dairy products hanging over the U.S. market." Again, it is clear the deficit markets NMPF references are regional in scope, not national.

With increased focus on the global marketplace and the current Doha Round of WTO negotiations, U.S. dairy policy and pricing needs to become more market oriented. NMPF's proposal moves in the opposite direction and also raises a question with FMMO's and the classified pricing system in relation to the WTO. A World Bank study in 2005 described the cross-subsidy that exists when consumers of premium or fluid dairy products subsidize the production of lower-priced manufactured products. The study "suggested that this implicit consumption cross-subsidy could be construed as an export subsidy if the United States then exports the lower-priced manufactured products." (Tom Cox and Yong Zhu, "Dairy: Assessing World Markets and Policy Reforms: Implications for Developing Countries" in *Global Agricultural Trade and Developing Countries*, Washington: World Bank, 2005) Similarly, in a 2004 study on the WTO ruling of the United States' "Step 2" cotton support program, Daniel Sumner from the University of CA at Davis, and also the former Assistant Secretary for Economics at USDA, drew a parallel to the current dairy programs of the United States.

> "The price discrimination and pooling schemes under the milk marketing orders stimulate overall milk production and divert milk from beverage products that are generally not traded internationally to the production of cheese, milk powder, and butter, which are the main traded dairy products... the net result is a lower price of the tradable products and displacement of imports or stimulation of exports." Boxed In: Conflicts between U.S. Farm

Policies and WTO Obligations, Cato Institute Trade Policy Analysis no. 32, December 5, 2005

With the potential for increased scrutiny of U.S. dairy policy and pricing systems, NMPF's proposal to increase Class I and II prices would only exacerbate this problem.

Emergency Marketing Conditions Do Not Exist

While NMPF has requested an expedited decision, the current supply and demand situation does not warrant it. It is clear that costs of production have increased, for example, the recent sharp increase in corn prices and the impact on feed costs. However, milk prices have remained higher than usually seen in expansionary phases of the milk cycle. Following two years where the all-milk price was the highest (2004) and third highest (2005) in history, it follows economic theory to see lower than average prices as supply responds to the price signal to expand. Indeed, milk production is up 2.8% vs. last year (October YTD) and cow numbers in October actually increased after remaining flat for several months. Furthermore, NMPF even uses the "surging" milk supplies in 2006 as a reason they increased the monthly CWT investment from $0.05 to $0.10/cwt on July 1. Additionally, a new dynamic has also helped increase dairy commodity and milk prices over the past two years -- the world market. With record-high whey prices and the highest NFDM price in many years, these gains alone have added more than $1/cwt to the all-milk price relative to their longer-term averages. Furthermore, current CME Class III milk futures prices for 2007 average nearly $14/cwt. Using a 10-year average difference between the Class III price and the all-milk price of $1.50, the futures outlook is for $15.50 milk for

2007, which would be the second highest milk price in history. An examination of the facts clearly shows emergency marketing conditions do not exist. Therefore, NMPF's request for an expedited or emergency decision should be denied.

Summary

Kraft Foods opposes NMPF's proposal to amend the Class I and Class II price formulas and sees no need for an emergency ruling. At a time when we should be considering simplification of U.S. dairy policy, NMPF's proposal adds unnecessary complexity to the system. It would have a negative impact on Class II products and result in regionally disproportionate benefits.

I appreciate the opportunity to present Kraft's viewpoint on this issue, and welcome questions regarding my testimony. Thank you.