United States Department of Agriculture

Agricultural Marketing Service

Federal Milk Order Hearing

December 11, 2006

Pittsburgh, PA

7 CFR Parts 1000, 1001, 1005, 1006, 1007, 1030, 1032, 1033, 1124, 1126, and 1131

(Docket No. AO-14-A76, et al; DA-07-01)

Statement of Dennis Tonak

My name is Dennis Tonak. I am the General Manager of Mid-West Dairymen's Company, 4313 West State Street, Rockford, Illinois 61102. I have over 30 years of experience in dairy marketing and Federal Order issues, especially in the geographic areas east of the Rocky Mountains. Prior to my employment with Mid-West Dairymen's Company I was employed with National Farmers Organization, Ames, Iowa and Southern Milk Sales, San Antonio, Texas in various marketing and management positions.

This testimony is on behalf of Mid-West Dairymen's Company, Manitowoc Milk Producers Cooperative, Milwaukee Cooperative Milk Producers, and Lakeshore Federated Dairy Cooperative in opposition to Proposals 1, 2, 3, 4 and 5. Lakeshore provides a vehicle through which Manitowoc, Milwaukee, and Mid-West participate in developing direction on dairy policy, legislative activities, and federal order issues. Lakeshore also provides other services and benefits to the members. Manitowoc,

Milwaukee, and Mid-West are all recognized as Capper Volstead cooperatives approved to provide Federal Order marketing services. We are concerned about producer income both near term and long term. We welcome efforts to improve producer income but prefer solutions that treat all regions equitably.

Mid-West has 157 farmer members located in northern Illinois and southern Wisconsin. The members' milk is currently pooled on Federal Order 30 and is used to supply a fluid milk plant (Muller Pinehurst) owned jointly by Mid-West and Prairie Farms Dairy. Mid-West also supplies other fluid and manufacturing use plants. Mid-West is a small business under the criteria established in the Hearing Notice. Virtually all of Mid-West's producer-members are small businesses. Mid-West is a member of National Milk Producers Federation.

Manitowoc Milk Producers Cooperative has headquarters in Manitowoc, Wisconsin and has approximately 3,000 dairy farmer members. The majority are located in Wisconsin, with the balance in surrounding states. Manitowoc provides marketing services for their members. The milk is pooled on Federal Orders 30 & 32. The farms deliver milk to both pool and non-pool plants. For purposes of this proceeding Manitowoc is a small business. The majority of Manitowoc's producer members would meet the small business definition. Manitowoc is a member of National Milk Producers Federation.

Milwaukee Cooperative Milk Producers is headquartered in Brookfield, Wisconsin and has approximately 700 dairy farmer members. The producers are located from eastern Nebraska to northern Indiana with the majority located in Wisconsin. Milwaukee provides marketing services for their members. The milk is pooled on Federal

Orders 30, 32, and 33. The farms deliver milk to both pool and nonpool plants. For purposes of this proceeding Milwaukee is a small business. The majority of Milwaukee's producer members would meet the small business definition.

National Milk Producers Federation speaks with one voice on behalf of the nation's dairy producers on many issues – environment, animal health, food safety – to name a few. On the issues before this proceeding National Milk is only speaking for a sliver of those dairy farmers affected by this regulatory process. It is apparent that National Milk does not speak for a number of its member cooperatives – Mid-West, Manitowoc, AMPI, First District, Prairie Farms, to name a few – on these proposals. Many of the largest NMPF members – LOL, DFA, California Dairies - have producers located in areas not regulated by Federal Orders or market milk not pooled on Federal Orders. As an example there is not a Federal Order in California-the largest milk producing state in the nation. The heavy milk production areas in Idaho, along with Utah, are outside of Federal Order boundaries. Most of Pennsylvania and some of New York are outside of defined Federal Order areas. Members of National Milk have producers in these areas that are outside of the Federal Order Marketing Area boundaries.

There are also cooperatives who are not members of National Milk who do not support NMPF's proposal.

Historical Perspective

Our approach to this proceeding is shaped by our view of the changes in milk marketing over the years. The role of Federal Orders evolved as changes in milk production, food processing, and transportation developed. In the earliest days of the Order program a marketing area was relatively small, may have involved only one

population center, and milk production and transportation characteristics defined milk movement. Bulk tanks at the farm level were non-existent. Milk was delivered to plants in cans – often cooled only with well water. Electrical power was limited. It was necessary to maintain a locally produced milk supply to meet the fluid milk needs of the local population.

When Federal Orders were initially formed it was difficult – if not impossible – to meet an area's fluid milk needs with milk production from distant locations. I will digress here to say that it is difficult to define "local" or "distant" milk but even when I can't define it I know it when I see it. Now milk is quickly chilled at the farm which greatly improves the quality. Interstate highways aid in the quick movement of both raw bulk milk and packaged milk from the production areas to the consumption areas. In this day and age milk movement over distances of a thousand or more miles can be readily accommodated. Due to the changes mentioned above the fluid milk needs for a population center can now be met with milk production from areas quite distant from that population center. We have changed from a local industry meeting local needs to a national industry capable of meeting local needs.

In the early days of Federal Orders a Class I price which was higher than the price for milk used in producing storable dairy products helped assure the production of milk for fluid use. The extra money found in this higher Class I price helped recover the added costs of producing Grade A milk and delivering the milk to the fluid use market. The Class I money was not widely shared. Individual handler pools were common. Access to participation in some Federal Order pools was tightly controlled by either the fluid handlers or the milk supply cooperatives. They wanted to retain the Class I money for

those who actually delivered to the fluid market and deny those who did not deliver to the fluid market access to the pool proceeds. As an example, in the early 1960's producers in the Rockford, IL area wanted their milk pooled on Order 38 – the Rock River Valley Order – and not on the larger Chicago Order which had a lower Class I use percentage and a lower producer price. A local Rockford dairy cooperative exerted great influence on who had access to the Order 38 pool.

USDA, in an attempt to correct these disorderly marketing conditions, oversaw the mergers of a number of Federal Orders from the late 1950's into the 1970's. It is during this time that the value difference between the Class I price and the manufacturing price started to shift from A) where Class I money attracted milk to fluid use to B) where Class I money through the blend price attracted milk to the Federal Order pool. Or perhaps it would be more correct to say that this functional shift from A) where Class I money attracted milk to fluid use to B) where Class I money through the blend price attracted milk to the Federal Order pool-this change became more pronounced and noticeable.

As more milk entered the larger pools, milk was encouraged to move to fluid use through negotiated premiums, location adjustments on producer milk, shipping requirements, and diversion limitations. The Class I price, since it was shared with all pool participants equally and not just those who supplied fluid use, was not sufficient standing alone to cause milk to move to fluid use.

Money Moves Milk, More Money Movers More Milk, Much More Money Moves Much More Milk (unless the money comes from a mandated Class I price increase). Since the Class I price in and of itself no longer moved the milk to the fluid market and

covered the costs (due to sharing with all pool participants) over order premiums emerged as a primary means of attracting milk to fluid use. The over order premiums are generally retained by those who supply the fluid market. Over order premiums are not shared with the Federal Order marketwide pool. In fact Over Order premiums now serve the same purpose as the Class I prices did in the early days of Federal Orders – that is to attract milk to fluid use.

What purpose does the Class I Price serve today? It attracts milk to the marketwide pool. The shipping and eligibility requirements, along with the transportation and assembly credits where available, encourage some milk to move to fluid use. In the Upper Midwest Order 10% of the pooled milk is required to move to fluid use. The balance of the Upper Midwest fluid milk needs are drawn to fluid use by the over order premiums. Thus a major paradigm shift in the purpose and function of the Class I price has occurred.

As this shift in the function of the Class I price has occurred, an effort has been made in some Orders to partially offset the costs of supplying milk for Class I use. Order 30, as an example, has an assembly credit provision and a transportation credit provision to aid those who supply milk to fluid use. In a general fashion, the money is generated from the Class I price – actually from the pool proceeds before the pool proceeds are distributed to all pool participants. These type of credits, along with the ability to share in the overall pool proceeds by meeting the required minimum shipping/ pooling requirements, are all that the Federal Orders provide in the way of an incentive to ship to fluid use. Once you meet the minimum requirements of the specific Order there is little incentive from the Order to make extra shipments for fluid use.

Historically, the Class I Price has been directly linked to prices for manufacturing milk. Since at least the early 1960's the Class I Price has been based on the Class III price, either directly or through a product price updater. This historical relationship was maintained with the initial completion of the Federal Order Reform process in January 2000. The Class II price has also been based on a manufacturing milk price. The NMPF proposals, while maintaining some relationship with product prices, completely divorces the Class I and II prices from the Class III and IV prices. This insulates the Class I and II prices from the realities of the marketplace as changes occur. The National Milk proposal is an attempt to do an end run around 40 plus years of Federal Order policy.

General Comments

There is not a crisis in national milk production. No change in the Class I Price formula is required. Per capita milk production has increased from 592 to 597 pounds between 1995 and 2005 on a national basis according to the Marketing Service Bulletin from the Order 32 Market Administrator. This has occurred during a time when milk prices have not been particularly profitable according to many accounts. Milk production nationally has climbed over nine billion pounds since Order Reform. Class I usage has not seen a similar increase.(Attachment A and B) The industry's ability to increase milk production capacity under very trying circumstances – extended periods of low prices, high production costs especially feed costs, and low farm returns - continues to amaze me.

In a perfect world we could develop a system that allows every producer to recover all costs associated with producing milk. This is not a perfect world. I have not seen any

indication that USDA or any other government agency is about to embark on a journey which would accommodate all dairy farmers in the recovery of all their milk production costs. The proposals by National Milk will enhance some producer income – and do so on a regionally inequitable basis – without regard for economic reality or the natural forces of a national marketplace.

There is not a large supply of non Grade A milk to recruit to Grade A status. My estimate is regular non Grade A milk production is slightly over 2.5 billion pounds. About one-third of that milk is produced in Wisconsin. Another one-third is produced in the combined states of California, Minnesota, and Ohio. Generally non Grade A milk is found in the Northern states and is nonexistent in the Southern states. (Attachment C) There is currently more than enough market place incentive to prompt those producers with the desire and management skills to produce Grade A milk to make the transition.

A non Grade A producer in Southern Wisconsin recently upgraded his dairy barn and milk room and began shipping Grade A milk. One of his largest expenditures was for "whitewashing" – a form of painting his barn. He also needed to repair some floors and the fit of a few doors. His total out-of-pocket cost was less than $500. He is shipping an average of 2,979 pounds per day. Over the course of the year his cost to convert to Grade A would be $.046/cwt.

Another Grade A producer with 8,796 pounds of daily production drilled a new well at a cost of approximately $12,000. If he had not drilled the well he would not have maintained Grade A status. A new well will often last for twenty or more years. Amortization of the $12,000 cost over a short five year period would give a cost to maintain Grade A status of $.0748/cwt. While individual situations may vary widely

depending on expense factors and milk production, these two examples illustrate that it does not take much money to justify maintaining or upgrading to Grade A status. Perhaps that is why such a large percentage of the nation's milk supply is Grade A. Feed costs, labor costs, costs of cleaning equipment, etc. do not change appreciably between the production of Grade A milk or non-Grade A milk. The cost of producing milk does not change as the utilization of Grade A milk changes from Class I or II to Class III or IV. A Mid-West member-producer's costs do not miraculously change when milk is diverted from fluid use to manufacturing use.

Mid-West is responsible for supplying the total raw milk needs of Muller-Pinehurst Dairy, an Order 30 pool distributing plant. The milk needs vary week to week and month to month over the course of the year. Mid-West balances Muller's raw milk needs through a combination of buying supplemental supplies from other pool handlers or selling milk to non-pool manufacturers, primarily cheese plants. When we look at Muller's milk needs over the course of the year and then arrive at an average or baseline, we find that there is a "deficit" situation for about six months and a "surplus" situation for about six months. During the past two years the surplus side has ranged from a high of 2,442,807 pounds in an individual month to a low of 12,945 pounds with an average of 1,501,497 pounds. The deficit sees similar numbers ranging from a shortage from the baseline of 3,057,134 pounds to 708,676 pounds depending on the month, with an average of 1,637,997 pounds. Variations from week to week are also present. In December Muller's weekly milk needs will change by an estimated 1.2 million pounds from early December to late December. These fluctuations in demand must be balanced.

When Mid-West purchases supplemental milk for Muller-Pinehurst, Federal Order 30 establishes a minimum Class I value. That value is shared with all pool participants – it is not retained by Mid-West or paid directly to the supplemental milk supplier. Other than the assembly credit and transportation credit received from the pool proceeds there is no direct incentive from the Class I Price or the pool proceeds to ship milk to fluid use. The incentive to ship supplemental milk comes from a payment to the supplemental supplier in the form of an over-order premium. It is the over-order premium that helps the suppliers of supplemental milk cover the transportation costs to the fluid market, the costs of daily and seasonal balancing through a manufacturing plant, and any "give up" charges. The minimum Federal Order Class I price does not cover any of these costs as they are incurred by the regular supplier, Mid-West, or the supplemental supplier.

When Muller-Pinehurst's milk needs move lower a "surplus" develops. At those times Mid-West balances the milk supplies by moving the "surplus" milk to manufacturing plants. Mid-West does not receive any money from the Federal Order pool in return for performing this balancing function. The Order minimum Class I price paid by Muller-Pinehurst does not pay for any of this surplus balancing cost. The costs of this function are paid for by Muller-Pinehurst through over order premiums or absorbed by Mid-West.

The seasonal swings we see at Muller are not that much different from the seasonal variations seen in Florida. The comparison of an average baseline at Muller's and Florida milk imports and exports may be somewhat of an "apples and oranges" comparison but it is still a valid comparison. The combined Florida and Southeast imports and exports are

higher in 2005 than in 2001, but the import/ export volume difference has lessened when 2001 and 2005 are compared. (Attachment D)

The changes proposed by NMPF will enhance pool proceeds, at least in the short term. The changes to the blend price will vary widely in different parts of the country. The Upper Midwest may see a short term 15 cents/cwt. improvement while Florida may see over 65 cents.

These price increases will be paid directly to producers. More milk will be produced. Since Class I consumption has been relatively stable the additional milk production will end up in cheese and butter and other manufactured dairy products. This will undoubtedly lead to lower prices. Simply put a higher Class I Price leads to more milk which leads to more cheese which leads to lower cheese prices which leads to lower milk prices. The impacts of the lower cheese prices will hit the areas with more cheese manufacturing – such as the Upper Midwest – first and hardest.

We are also concerned about the impact of a non marketplace driven price increase on consumption. USDA used a price elasticity factor of -.05 in their analysis of this proposal. Chapter 3 (The Cornell Analysis) Table 3-1 of the USDA "Report to Congress on the National Dairy Promotion and Research Program and the National Fluid Milk Promotion Program" from July 2006 used a factor of -.114. I am not an economist but these different elasticity factors raises questions? Is it possible that the increase in the Class I mover proposed by NMPF will reduce Class I consumption by over double the number contemplated in the USDA analysis (-.05 versus-.114)?

It is our view that changes in the milk and competitive beverage segments in the marketplace are leading to much larger elasticity values traditionally believed. It is within

the realm of possibility that we are actually approaching an elasticity value closer to that of other dairy products. If this is true we could easily see a 1%-2% decrease in milk consumption with the artificial 5% increase in the proposed changes to the Class I price mover.

The large change in the Class II butterfat price formula causes us great concern. Along with fluid milk the Muller operation also produces ice cream. The ice cream production helps us balance our milk needs-there is limited ice cream produced in the winter months with heavier production in the summer. Muller would face an increased Class II butterfat cost while a stand alone ice cream plant, and this is becoming quite common, could find butterfat sources from outside Federal Order price regulations. Cream moves from unregulated areas in the West to butter churns in the Midwest. That cream could just as easily move to a stand alone ice cream plant. This would put the Muller ice cream operation and any other ice cream maker embedded in a fluid plant operation at a great competitive disadvantage.

Emergency Conditions

Emergency conditions do not exist. There is a more than adequate supply to meet the Class I and II needs of the market place. The NMPF proposals request a major shift in how Class I and Class II prices are determined. Changing from Class III and IV milk price formulas with a differential value to a decoupled product formula for the determination of Class I and II prices should not be undertaken on an emergency basis.

The short notice time for this proceeding also begs that all views be fully and completely aired and commented upon before any change is made to the current regulations.

Thank you for your consideration.

A

Summary --- Dairy Market Statistics, Annual Summary, 2000-2005

Table 32-Annual Price and Pool Statistics

	Producer Receipts (million pounds)	Class I Utilization (million pounds)
2000	116,919	45,990
2001	120,223	45,887
2002	125,546	46,043
2003	110,581	45,843
2004	103,048	44,940
2005	114,682	44,570

B

Summary --- Dairy Market Statistics, Annual Summary, 2000-2005

	Table 1-Milk Production (million pounds)	Table 29-Packaged Sales of Fluid Products (million pounds)
2000	167,559	51,611
2001	165,497	51,240
2002	170,063	55,262
2003	170,394	54,981
2004	170,934	54,524
2005	176,989	54,543

C

Table 8-13.—Milk: Quantities used and marketed by producers, by States, 2003 (preliminary)

State	Milk used where produced			Milk marketed by producers	
	Fed to calves [1]	Used for milk, cream, and butter	Total	Total quantity [2]	Fluid grade [3]
	Million pounds	*Million pounds*	*Million pounds*	*Million pounds*	*Percent*
AL	1	1	2	250	100
AK	0.7	0.4	1.1	15.6	100
AZ	12	1	13	3,441	100
AR	5	3	8	344	100
CA	32	5	37	35,400	99
CO	27	5	32	2,145	100
CT	2.5	0.5	3.0	410.0	100
DE	1.0	0.1	1.1	134.9	100
FL	4	1	5	2,156	100
GA	10	1	11	1,433	100
HI	1.0	0.5	1.5	90.5	100
ID	32	3	35	8,739	99
IL	10	2	12	2,035	98
IN	21	3	24	2,920	97
IA	30	11	41	3,739	98
KS	10	1	11	2,104	100
KY	29	2	31	1,433	100
LA	9	2	11	508	100
ME	4.5	0.5	5.0	619.0	100
MD	7	3	10	1,222	100
MA	3.0	1.0	4.0	328.0	100
MI	55	5	60	6,300	99
MN	95	5	100	8,158	96
MS	1	1	2	421	100
MO	21	5	26	1,860	96
MT	3	3	6	340	100
NE	11	1	12	1,117	99
NV	5	1	6	479	100
NH	2.5	0.5	3.0	302.0	100
NJ	2	1	3	213	100
NM	62	20	82	6,584	100
NY	45	2	47	11,905	100
NC	9	4	13	1,031	100
ND	10	1	11	543	76
OH	25	5	30	4,460	93
OK	13	1	14	1,298	100
OR	14	2	16	2,161	100
PA	10	1	11	10,327	99
RI	0.1	.....	0.1	21.9	100
SC	2	1	3	315	100
SD	9	2	11	1,314	93
TN	4	1	5	1,200	100
TX	17	2	19	5,611	100
UT	12	2	14	1,601	98
VT	14	2	16	2,621	100
VA	6	2	8	1,723	100
WA	27	2	29	5,552	100
WV	2	1	3	219	100
WI	234	30	264	22,002	96
WY	1.0	0.2	1.2	52.8	79
US [4]	963	151	1,114	169,198	98
PR	6	2	8	812	99

[1] Excludes milk sucked by calves. [2] Milk sold to plants and dealers as whole milk and equivalent amounts of milk for cream. Includes milk produced by dealers' own herds and small amounts sold directly to consumers. Also includes milk produced by institutional herds. [3] Percentage of milk sold that is eligible for fluid use (grade A for fluid use in most States). Includes fluid-grade milk used in manufacturing dairy products. [4] May not add due to rounding.

NASS, Livestock Branch, (202) 720–3570.

D

Summary --- Dairy Market Statistics, Annual Summary, Table 27, 2002-2005

	FLORIDA		SOUTHEAST	
	imports	exports	imports	exports
2001	1523	2919	1969	0
2002	2406	1924	0	23
2003	2696	2819	310	0
2004	3187	3712	364	0
2005	3480	4214	1210	237