

Testimony of
Mary Keough Ledman
On Behalf of
The Dean Foods Company

Hearing to consider amendments to the Upper Midwest

Federal Milk Marketing Order

Docket No. AO-361-A39; DA-04-01

August 16 et seq, 2004

My name is Mary Keough Ledman. I reside at 1642 Old Barn Circle, Libertyville, Illinois 60048. I am an agricultural economist that provides consultation to the dairy industry. My previous public service includes employment with USDA's Federal Order 30, Glen Ellyn, Illinois, and the Foreign Agricultural Service and the National Agricultural Statistic Service in Washington, D.C.. My private sector experience includes: Manager of Dairy Economics for Kraft Foods and Director of Materials Planning for Stella Foods. For the past ten years, I have been employed by Keough Ledman Associates, Inc. a dairy economic consulting firm that provides:

- Monthly dairy product and milk price forecasting
- Economic, financial and policy analysis
- Dairy product and milk sourcing strategies
- Domestic and international market information
- Expert Witness Testimony

I appear here on behalf of Dean Foods in support of proposal number 3 and closing the depooling loophole.

My interest in the economic impacts of liberal pool regulations is not new. In September 2002, *Hoard's Dairyman*, (Ex ____) published an article that I wrote that outlined how liberal depooling contributed to the unpredictability of the Producer Price Differential.

Prior to 2002, the more egregious depooling was done by the end users of Class II and Class IV milk. The concerns of liberal depooling regulations became more in vogue in 2003 and 2004 when Class III end users and by far the largest volume of milk normally associated with the pool jumped ship. It is my opinion that liberal pooling, regardless of class, undermines orderly marketing and the ability of all dairy producers to share equally in the pool, two of the early premises of the Federal Milk Marketing Orders.

When asked to describe disorderly marketing, many joke, "I can't describe it but I'll know it when I see it." Well folks I think that we have all seen disorderly marketing, of different magnitudes, since the implementation of Federal Order Reform in 2000. That is not to say that these situations did not also occur prior to 2000. However, several factors included in Federal Order Reform have led to increased disorderly marketing. Those factors include:

- The "higher of" setting the Class I mover.
- The use of NASS dairy product prices in tandem with advance pricing.
- The easy entry and exit to Federal Order pools (liberal pooling regulations).

Since we are only skinning one of these cats today, I'll stick to the liberal pooling regulations.

Historically, the concept of pooling within the Federal Orders was designed for all producers to share equally in the pool while the system of classified pricing ensured that all Grade A milk was utilized in the highest valued class. Unfortunately neither is true today.

The system worked well when there was just two or three classes of milk and when Class I utilization dominated the market. However, increased U.S. milk production in tandem with lower per capita milk consumption has resulted in greater manufacturing utilization and has increased the incentive for manufacturers to jump in and out of the pool. Furthermore, the ability to depool milk provides a disincentive to move milk into its highest valued use. An excellent example of this occurred in November 2000.

In November 2000, the Federal Order announced Class III and IV milk prices were \$8.57 and \$13.00, respectively. The blend price for Federal Order 30 was \$10.00 per cwt (Ex 5. Table 3). If the classified pricing system truly moved milk to its highest valued use, Class III manufacturers would sell their milk to butter-powder plants. Even if the cheese manufacturer received just the blend price of \$10.00 for its milk, it would seem that the plant would be receiving \$1.43 per cwt more for the milk vs. using it in cheese production.

In the real world the cheese manufacturer is indifferent to selling its milk to the butter-powder plant because it will draw the difference between the Blend Price and the Class III price to pay its producers. On the other hand, selling the milk to the Class IV manufacturer that depools the milk will place the cheese manufacturer at a competitive disadvantage in the country procuring milk from dairy producers. Since the Class IV manufacturer depools its milk, it could pay its patrons \$12.00 per cwt. The patrons would be "better off" by \$2.00 cwt vs. the Blend Price and the manufacturer could pocket the remaining \$1.00 cwt for other uses.

Still, the other producers and manufacturers in the marketing area lose as do consumers. Producers receive a lower Blend Price due to the depooling of the higher priced classes of milk. Cheese manufacturers within the marketing area face greater competition procuring milk and have no incentive to sell milk to a Class IV manufacturer that does not pool the milk. The disincentive to sell milk to the Class IV manufacturer results in less butter production, more volatile butter prices and higher butterfat costs to consumers. The CME grade AA butter price averaged \$1.15 per pound in October 2000, followed by \$1.65 per pound in November and \$1.37 per pound in December according to USDA's Dairy Market News Monthly Products Price Summary 2000.

As illustrated by the above example, the ability to depool does not promote orderly marketing or equitable sharing of pool revenue among dairy producers, two of the early goals of the Federal Orders. How much money is left on the table due to depooling? In November 2000, it is estimated that the Uniform Blend Price and the PPD in the Upper Midwest Order would have been a dime higher if all the Class II and IV milk would have been pooled. That would have added an additional \$2.3 million to producers in that market area.

The November 2000 example could be considered by some a minor irritant compared to the virtual all out evacuation of Class III milk from the pool during 2004. The variation in the volume of Class II and IV milk pooled on the order swings by millions of pounds not billion of pounds. According to Table 2e Producer Milk by Class January 2000 to June 2004, as prepared by the Market Administrator's Office, the volume of Class III milk on the pool varied from 1.5 billion pounds and 68.9% of the pool in January 2004 to just 11.0 million pounds and 1.8% of the pool in April 2004. It is estimated that Uniform Blend Price and the PPD in the Upper Midwest Order would have been \$2.97 per cwt higher, albeit still negative at \$1.12 per cwt, if all Class III milk had been pooled in April 2004 (Ex. 10 Table 3 PPD).

It is my opinion that the large shifts in the monthly volume of milk pooled on the Federal Orders results in disorderly marketing and prevents dairy producers sharing equally in the value of classified pricing. Using data from Table 2e, Producer Milk by Class January 2000 to June 2004, as prepared by the Market Administrator's Office (Ex. 10 Table 2e), I analyzed the monthly variation in pooled milk by class (see Table 1). Since Class I milk is the only class of milk that must be pooled, it comes as no surprise that the least amount of variation in the volume of milk pooled occurs in Class I.

Table 1. Percent Variation in Monthly Pool Volumes by Class, 2000 – June 2004.

Percent Variation in Monthly Pool Volumes					
	Class I	Class II	Class III	Class IV	Total
2000	15%	39%	38%	81%	33%
2001	16%	49%	21%	77%	19%
2002	18%	26%	26%	76%	22%
2003	19%	64%	98%	83%	70%
YTD 2004	12%	45%	99%	64%	72%

Source: USDA Table 2e, Producer Milk by Class January 2000 to June 2004
 Compiled by Keough Ledman Associates, Inc.

When asked to describe pooling, I compare it to a poker game. First, if you are representing a Class II, III, or IV manufacturer you analyze your cards, in this case the classified prices, and estimate a blend price. If it appears that your company has more to win than lose, you ante up, join the pool, and share in the revenue pot. If it appears that your company has more to lose than win. That is, it will pay more into the pool than it draws out. The company just folds and waits for the next hand. The only exception is for the Class I handler. It has to ante-up for every hand, good or bad. And, the Federal Order system deals a new hand each and every month to play.

Over Order Prices

Consumer voices are often silent in these proceedings. As a consumer who purchases from five to six gallons of milk per week, I notice milk prices. It's also been my experience this summer that many of my neighbors who are aware of my occupation have asked me, "When are milk prices coming down?" or "Why are our milk prices higher than Michigan or even Florida?"

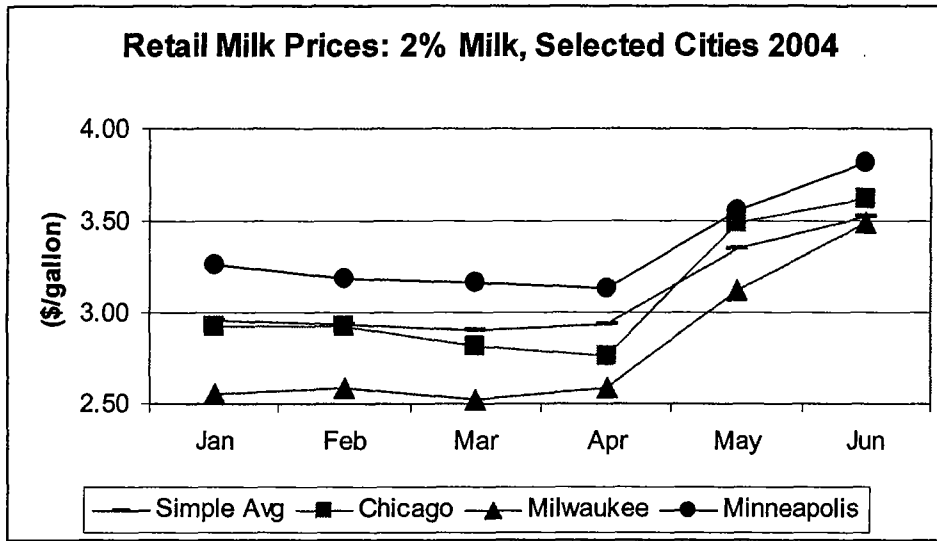
I recently reviewed USDA retail price data, as collected by AMS, to provide comments on a retail milk pricing story. It was then that I discovered that the retail milk prices for whole milk and 2 percent milk in both the Milwaukee and Chicago markets increased more than the farm level increase. That is, the class I mover price increase from April through May 2004 adjusted for milk composition. For example the Class I mover, when adjusted for 2 percent milk composition, increased \$0.71 per gallon while the whole milk price increased almost \$0.78 per gallon. The average 2 percent retail milk price in Milwaukee increased \$0.97 per gallon while the Chicago price increased \$0.80 per gallon. The retail whole milk price also posted similar gains (Ex. ___ Retail Milk Price Survey by USDA).

Before jumping to the conclusion, that some company was enhancing retail milk prices, I reviewed the Announced Cooperative Class I Prices in Selected Cities, as published in *Dairy Market News*. These data illustrate that the Cooperative Over-Order Premium in the Chicago and Milwaukee markets increased from \$1.80 per cwt in March 2004 to \$2.25 in April, to \$3.72 in May. That equates to a 16.5¢ per gallon raw material price increase due to the higher Cooperative Over-Order Premium (Ex. ___ Announced Class I Prices in Selected Cities)

In fact, the three major cities within Order 30 posted by far the highest Cooperative Over-Order premiums averaging more than \$3.00 per cwt from April through August 2004. The next highest Cooperative Over-Order Premium was for the Miami market at \$2.10 per cwt.

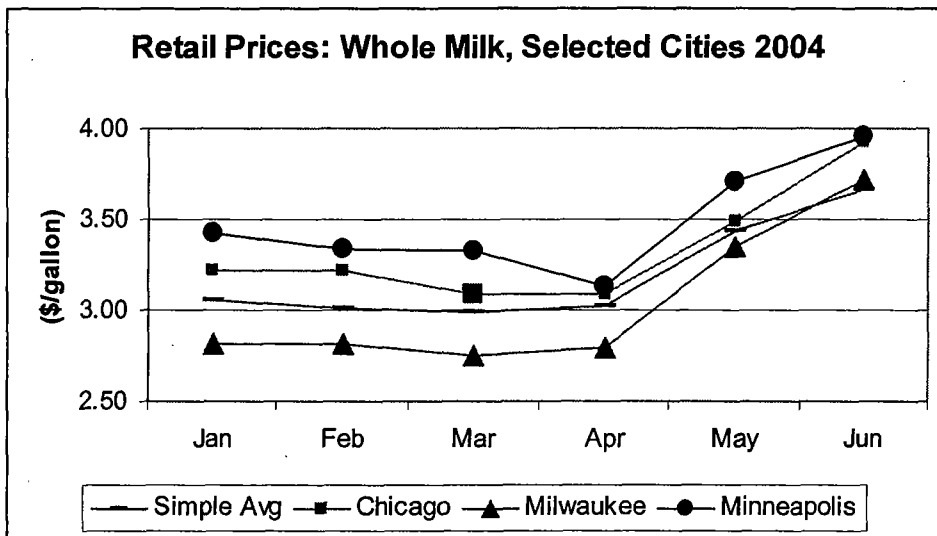
As a result of the highest Over-Order Premiums, the retail 2 percent milk prices in Milwaukee and Chicago increased 36% and 23% more than the average retail milk price increase of \$0.62 per gallon from April through May 2004. Figures 1 and 2 illustrate the dramatic increase in the retail milk prices from January through June 2004.

Figure 1. Comparison of Retail 2% Milk Prices, Selected Cities, 2004



Source: USDA, Compiled by Keough Ledman Associates, Inc.

Figure 2. Comparison of Retail Whole Milk Prices, Selected Cities, 2004



Source: USDA, Compiled by Keough Ledman Associates, Inc.

What caused the Cooperative Over-Order Premium to rise to the highest level in the Upper Midwest during Q2 2004? The simple answer is competition for milk. Record high Chicago Mercantile Exchange cheese prices, an extremely favorable milk price to cheese price relation and the ability to depool kept all the milk in the cheese vats particularly in April.

The cheese to milk price relationship, sometimes referred to as the spread, is the difference in the Class III milk price compared to the average CME block cheese price times ten, assuming a

cheese yield of ten pounds of cheese from a hundredweight of milk. A typical spread is near \$0.08 per pound of cheese. Table 2 illustrates that the spread was exceptional in April but was actually negative in May. According to USDA, the Mailbox milk price for May in Wisconsin was \$20.39 per hundredweight, within three cents of the theoretical value of milk used to manufacture cheese, but \$0.22 per hundredweight less than the announced Class III milk price.

Table 2. Cheese Milk Price Relationship

	April	May
Class III Price	\$19.66	\$20.58
CME Block Price	\$2.22	\$2.04
Block * 10	\$22.20	\$20.36
Spread per Cwt Milk	\$2.54	(\$0.22)
Spread per/lb. Cheese	\$0.254	(\$0.02)

Source: USDA Dairy Market News, Keough Ledman Associates, Inc.

The Class III price sets the competitive stage in Order 30. In April 2004, when the class III price exceeded the blend price by \$4.11 per cwt, Class I users anted up \$2.25 more for milk followed by a bump to \$3.72 per cwt the next month. Despite the positive \$0.30 per cwt draw from the pool in June, and a \$3.45 higher Class I mover vs. the Class III price, the Cooperative Over Order Premium really hasn't budged and neither have my retail milk prices.

Table 3. Various Milk Prices, January through Current 2004.

	Jan	Feb	Mar	Apr	May	June	July
Mailbox Price	\$ 13.34	\$ 13.80	\$ 16.13	\$ 19.89	\$ 20.39		
Blend Price	\$ 11.98	\$ 12.36	\$ 14.70	\$ 15.55	\$ 18.61	\$ 17.98	
Class III Price	\$ 11.61	\$ 11.89	\$ 14.49	\$ 19.66	\$ 20.58	\$ 17.68	\$ 14.85
Mailbox vs. Blend	\$ 1.36	\$ 1.44	\$ 1.43	\$ 4.34	\$ 1.78		
Mailbox vs. Class III	\$ 1.73	\$ 1.91	\$ 1.64	\$ 0.23	\$ (0.19)		
Blend vs. Class III	\$ 0.37	\$ 0.47	\$ 0.21	\$ (4.11)	\$ (1.97)	\$ 0.30	
Class I Mover	\$ 11.85	\$ 11.59	\$ 11.94	\$ 13.64	\$ 19.65	\$ 21.13	\$ 17.95
Class I Mover vs. III	\$ 0.24	\$ (0.30)	\$ (2.55)	\$ (6.02)	\$ (0.93)	\$ 3.45	\$ 3.10
Class I Over Order							
Chicago	\$ 1.71	\$ 1.95	\$ 1.80	\$ 2.25	\$ 3.72	\$ 3.63	\$ 3.72
Milwaukee	\$ 1.86	\$ 1.95	\$ 1.80	\$ 2.25	\$ 3.72	\$ 3.63	\$ 3.72

Source: USDA

More Negative PPD's to Come

As part of my consulting business, I forecast the Class I, II, III and IV prices for the next 12 months. It is my opinion that Order 30 is likely to face another negative PPD situation in September 2004. The key driver of this situation is the rising CME cheese prices. The Advanced Class I milk price announced this Friday, August 21st is likely to be near \$13.99 per cwt. Assuming that the CME block cheese price is \$1.60 per lb. for the remainder of August and September, the Class III price is estimated at \$14.89 per cwt. Further, the Class II and Class IV prices are forecast at \$13.01 and \$12.35, respectively. Table 4 illustrates, that based upon my estimates, that the estimated blend price including Class III milk would be near \$14.85 per cwt.

Given that the Class III price is estimated at \$14.89, plus the additional Market Administrator's fee of nickel, it is very likely that Class III milk will be depooled from the market.

Table 4. Estimated PPD including Class III milk in the Pool, September 2004.

	Estimated Class Price	Estimated Utilization	Estimated Blend Impact
Class I Mover	\$13.99		
Class I Differential	\$1.80		
Class I Milk Price	\$15.79	20%	\$3.16
Class II Milk Price	\$13.01	5%	\$0.65
Class III Milk Price	\$14.89	70%	\$10.42
Class IV Milk Price	\$12.35	5%	\$0.62
			\$14.85

Source: Keough Ledman Associates, Inc.

Table 5 illustrates that if Class III milk is depooled in September 2004, the estimated blend price falls by \$0.40 per cwt to \$14.45. The revenue to dairy producers serving the market is lower. However, the competitive landscape in the Upper Midwest will likely force Class I, II and IV handlers to cough-up an additional \$0.40 per cwt to match milk prices set by cheese manufacturers that have jumped the pool.

Table 5. Estimated PPD with Class III Depooled, in September 2004.

	Estimated Class Price	Estimated Utilization	Estimated Blend Impact
Class I Mover	\$13.99		
Class I Differential	\$1.80		
Class I Milk Price	\$15.79	50%	\$7.90
Class II Milk Price	\$13.01	18%	\$2.34
Class III Milk Price	\$14.89	10%	\$1.49
Class IV Milk Price	\$12.35	22%	\$2.72
			\$14.45

Source: Keough Ledman Associates, Inc.

In conclusion, it is my opinion that the Federal Order pricing and pooling practices fail to ensure that milk flows to the highest value use. The liberal pooling regulations promote disorderly marketing and provide free-riders the opportunity to play the system. Meanwhile, consumers of fluid milk, who live in what is referred to as a surplus milk area, pay some of the highest retail prices for milk in the United States.

Appendix A

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Professional Experience

Keough Ledman Associates (KLA) - Principal - Jan. 1995 - present

Keough Ledman Associates provides consulting services to clients desiring timely and accurate information covering the dairy industry. Associates services include but are not limited to:

- Monthly dairy product and milk price forecasting
- Economic, financial and policy analysis
- Dairy product and milk sourcing strategies
- Domestic and international market information and development
- Expert Witness
- Editor, Chicago Mercantile Exchange's *Daily Dairy Report*

Stella Foods, Inc. - Director of Materials Planning - Mar. 1994 - Dec. 1994

Responsible for purchasing 4 billion pounds of milk and 20 million pounds of nonfat dry milk powder used in Stella's 10 manufacturing facilities across the United States. Negotiated co-op milk contracts in California and Michigan. Provided product price forecasts and was a member of the supply chain management team. Served on the industry's Federal Orders legislative committee.

Kraft Jacobs Suchard - Germany - Manager of Strategic Planning - Jun. 1993 - Dec. 1993

Introduced and directed parent company (Philip Morris) mandated annual and quarterly strategic planning and reporting requirements. Provided weekly and monthly business performance reports and forecasts to the International Headquarters in Zurich and New York.

Kraft USA - Manager, Dairy Economics - Jan. 1992 - May 1993

Responsible for the economic analysis and forecasting of economic trends in the domestic and international dairy industry. Provided leadership relating to price forecasting, facilities planning, strategic supplier alliances and KGF's positions on government policy. Acted as liaison to President of Kraft USA serving on the National 4-H Board of Trustees. Coordinated the Dairy Economics' Plan Analysis including regional milk production trends, fluid milk consumption trends and domestic and international policy issues. Assisted Kraft USA Operations Strategy with the Strategic Plan, facilities planning regarding California milk costs and Northeast versus Midwest costs analysis. Prepared and presented Dairy Situation and Outlook to KGF strategic partners. Testified on behalf of KGF at the Southern Michigan Milk Marketing Order Hearing regarding component pricing and quality payments.

U.S.D.A. - National Agricultural Statistics Service - Nov. 1990 - Jan. 1992

Compiled, analyzed and published monthly and annual state and national prices for 20 commodities including the Minnesota-Wisconsin milk price, grains, dairy and livestock. Established and maintained technical assistance to each state office. Assisted field offices with primary and secondary data collection during annual survey. Participated on a cross-agency task force evaluating alternative milk pricing policies.

Professional Speaking Engagements

American Dairy Products Institute Annual Meeting speaker 2004
Wisconsin Cheesemakers Annual Meeting speaker 2004
Pennsylvania Dairy Stakeholders Annual Meeting speaker 2003
National Dairy Leaders Conference speaker, 1999, 2001, 2002
The U.K. Annual Dairy Conference speaker, Birmingham, England May 2002
Milling and Baking Annual Purchasing Seminar, Kansas City, MO June 2000, 2001, 2002, 2003
International Dairy Foods Association, Dairy Forum, Miami, FL January 2001
Global Livestock Conference, Braunschweig, Germany September 2000
National Dairy Leaders Conference, Monterey, CA October 1999.
Wisconsin Dairy Products Association Annual Meeting, August 1999.
California Dairy Institute, Annual Spring Meeting, So. Laguna, CA, May 1997
International Dairy Foods Association, Dairy Show, Chicago, IL, October 1997
International Dairy Foods Association, Dairy Show, Dallas, TX, September 1996.
California Dairy Institute, Annual Spring Meeting, Napa, CA, May 1996.
Chicago Federal Reserve Bank, Assessing the Midwest Economy - Dairy Impact - March 1996.
International Dairy Foods Association, Dairy Forum, Phoenix, AZ, January 1996.
International Dairy Foods Association, Dairy Forum, Palm Springs, CA, January 1995.
The German Dairy Export Council, "GATT - A U.S. Dairy Perspective," presented in German, Bremen, October 1995.
Federal Reserve Bank Committee on Agriculture & Rural Development, Chicago, IL, July 1992.
International Livestock Congress, Houston, TX, February 1992.
International Dairy Foods Association, Dairy Forum (Invited), Orlando, FL, January 1992.
National Milk Producers Annual Meeting, Orlando, FL, December 1991.
International Dairy Foods Conference, San Antonio, TX, October 1991.

Education

Master of Science (Thesis Option) - Agricultural Economics - Texas A&M University 1990
Thesis: "A Comparison of Product Price Formulas as an Alternative to the Minnesota-Wisconsin Price."

Fulbright-Hayes Scholarship - Georg-August University, Goettingen, Germany
Research Topic: Comparison of U.S. and European Dairy Policies

Membership

American Agricultural Economics Association - Member
Farm Foundation - Member
Wisconsin FFA Foundation - Sponsors Board Member

Appendix A:

Keough Ledman Associates provides consulting services to clients desiring timely and accurate information covering the dairy industry. Keough Ledman Associates services include but are not limited to the following:

- Monthly dairy product and milk price forecasting
- Economic, financial and policy analysis
- Dairy product and milk sourcing strategies
- Domestic and international market information and development

The proprietor of Keough Ledman Associates is Mary Keough Ledman. Mary has over twenty years of experience in the dairy industry that includes production, processing and policy.

Mary was introduced to the dairy industry at a young age. She and her four brothers and sister grew-up on a 160-acre, 50-cow dairy farm in southern Wisconsin. Mary was active in the Future Farmers of America. She served as a State FFA Officer and received the American Farmer Degree. In addition, Mary participated in the FFA international exchange programs. She has production agriculture experience from dairy farms in Germany, Japan and New Zealand.

After graduation from Texas A& M University, Mary joined the United States Department of Agriculture's Foreign Agricultural Service. She assisted in establishing the first Dairy Export Incentive Program (DEIP) product allotments and was a member of the technical support team of the U.S. Canadian Free Trade Agreement.

In 1987, Mary took a leave of absence from USDA when she received a Fulbright Fellowship to study the European Community's dairy policy at the University of Goettingen, Germany. After a year in Germany, Mary returned to Texas A&M to complete a Master of Science degree in Agricultural Economics.

Mary's Master degree thesis on alternatives to the Minnesota-Wisconsin price series, led her to a position with the National Agricultural Statistics Service. There she was responsible for calculating and publishing 28 price series, including the Minnesota-Wisconsin Price Series.

Mary's private sector experience began as the Manager of Dairy Economics for Kraft Foods USA. She was responsible for the economic analysis and forecasting of economic trends in the domestic and international dairy industry and facilities optimization studies. Later Mary transferred to Kraft International and worked for Kraft Jacobs Suchard in Bremen as manager of Strategic Planning and Financial reporting. After returning to the U.S, she obtained the position of Director of Materials Planning for Stella Foods, Lincolnshire, Illinois.

In January 1995, Mary founded Keough Ledman Associates, a dairy economic consulting firm, that provides monthly dairy product and milk price forecasting, economic and financial analysis, dairy product and milk sourcing strategies and domestic and international dairy market information. Since 2000, Mary has also been the co-editor of the Chicago Mercantile Exchange's Daily Dairy Report.