

Ag Economist Ken Bailey testifies against raising make allowance, sheds light on industry and farm level impact

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STRONGSVILLE, Ohio -- "A higher make allowance results in more money going to processors and less to farmers. It's that simple," said Dr. Ken Bailey, professor of agriculture economics at Penn State University during a phone interview this week. Bailey testified here on September 14 at USDA's make allowance hearing. He testified in his capacity as a professor of economics and discussed the results of his own farm-level impact study, conducted with the help of graduate student Mirjana Pajic.

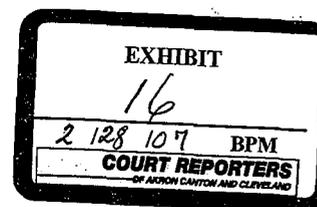
He spent a grueling two and one half hours on the witness stand, responding to questions from industry attorneys. "They weren't happy with what I had to say, but my bottom line is: if prices are bad right now (for producers), and they take off another 50 cents based on an administrative hearing, our producers will find that to be outrageous. Now if processor costs had really gone up and that's the way the system works, farmers would have to pay more... but it was not apparent to me that that's what happened, and for some processors (larger/more efficient), their costs are manageable. Based on our farm level impact study and the Cornell study, my conclusion is that—other than for whey—the current make allowances are in line with what would be expected for an efficient processing plant."

Bailey also notes that part of the problem is that from the processing side, everyone is making more cheese. Cheese plants have expanded and large new cheese plants have been built. "If current cheese make allowances are so bad, why are we building more cheese plants? We need to find other product outlets for these components," Bailey observes. In other words: guaranteeing a higher margin for all processors will just result in more cheese being produced--counterto what the market can bear—because larger, more efficient plants that are already making a profit, would be able to make even more profit with a higher make allowance. A higher make allowance would do nothing to stimulate market development for milk components in the manufacture and sale of other dairy products that could result in a more sustainable demand for more milk and milk components.

"We're in a unique situation here in Pennsylvania and the Mid-Atlantic states, where more and more of our milk is funneled into fluid and Class 11 uses," Bailey explains. "The real focus of the USDA hearing was cheese processors. Yes we have cheese processors in Vermont and New York and of course the upper Midwest, but is it really in our best interest here to increase the make allowance when all it will do is take more dollars out of the pool and provide it to processors who don't even make cheese?"

Some excerpts from Bailey's testimony follow. His full testimony plus a video of additional comments can be viewed at Penn State's dairy outlook website:
<http://dairyoutlook.aers.psu.edu/Hearing.htm>

During his opening comments, Bailey testified: "U.S. dairy producers participate in a national market and are under intense economic pressure to lower costs, expand, modernize, become more efficient, possibly relocate, or exit the market." He cited USDA



numbers indicating that the number of farm operations with milk cows fell 19.7% from 97,560 farms in 2001 to 78,295 farms in 2005.

"During this same time period, the U.S. milk supply grew 7.1%," Bailey continued. "Market pressures resulted in fewer farms, (and these farms) becoming more efficient. Processors located in federal orders don't face the same economic incentives. They face regulated make allowances for the processing of American cheese, butter, nonfat dry milk and dry whey. As long as their costs are in line with national averages and they meet minimum quality standards, they will have the opportunity to cover costs and earn a return on their investment. I have told dairy producers in Pennsylvania that they must face competitive markets and that processors face this regulated margin. I explain that this is the trade off for having federal orders. If the make allowance is set too low plants will not be able to recover their costs. However, if set too high, plants will have less incentive to modernize their plants and lower per unit costs. Also, they will have an incentive to expand production despite market conditions. This will lower commodity prices and hence farm-gate milk prices."

Bailey's objective was to present his study, which evaluated the impact of make allowance changes on federal order prices, the uniform blend price, and pool values for 2006 and 2007. "We analyzed six alternative scenarios for changes in make allowances," he said. "These scenarios are based on results from a Cornell study conducted by Mark Stephenson on dairy processing costs (Sept. 1) as well as his testimony presented at this hearing. We used a Penn State dairy industry model to conduct the study. This model is a monthly dynamic model that reflects the details of federal milk marketing orders. The monthly results were averaged and summed for 2006 and 2007."

After discussing the scenarios, Bailey testified: "In my opinion, current make allowances are set at a level that has allowed processors to expand plant capacity and production levels. For example, data from USDA's Dairy Products report indicates that total cheese production in the U.S. continues to grow year after year and is above the five-year average for 2001-2005. And two large and efficient cheese plants have been built in the West within the last year. The point is, these two facts would not be possible if current make allowances are too small. This hearing is being conducted during a time period where milk prices are relatively low. The Class III price averaged \$12.62 per cwt during the ten-year period 1996-2005. For 2006 I am forecasting it will be \$11.81 per cwt., 6.4% below the ten-year average. Clearly dairy producers will scrutinize every penny deducted from the federal order pools in this current marketing environment."

Bailey also stated that "individual processing plants should face the same economic realities that dairy producers face: they should lower costs, expand, modernize, become more efficient, possibly relocate, or exit the market." He concluded by testifying that "given the current environment of low milk prices, USDA should be very cautious about increasing make allowances from current levels due to their negative impact on farm-gate milk prices."

USDA is expected to make its decision based on testimony from this hearing plus testimony before its deadline of September 30. No word yet on when a decision will be forthcoming.

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