

United States Department of Agriculture

Agricultural Marketing Service

EXHIBIT NO. <u>38</u>
Metropolitan

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Docket No. AO-313-A48

Milk in the Central Marketing Area

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I am Neil Gulden, Director of Fluid Marketing for Associated Milk Producers Inc. (AMPI). My office address is 315 North Broadway, New Ulm, Minnesota, 56073.

My testimony is in opposition to DFA/Prairie Farms proposal 2, and Dean proposals 6-8, addressing the issue of repooling milk after voluntary depooling. I am joined in that opposition by Foremost Farms, Land O'Lakes, Central Equity, National All-Jersey. This coalition, based upon June 2004 information represents about 2,400 dairy farmers and over 360 million pounds of Order 32 milk.

We oppose DFA/Prairie Farms and Dean proposals 2 and 6-8 for three principal reasons:

First, price inversion and depooling is a national issue resulting from price formulas and the timing of price announcements. We strongly believe that the issue should be addressed in a national hearing in which USDA is not self-limited by the scope of a local order hearing notice, and may at least entertain price formula and announcement timing as alternative remedies.

Second, we endorse the view expressed by a witness for DFA and Prairie Farms at the last Mideast Order hearing that restrictions on voluntary depooling due to price inversions ^{may} cause financial damage to be born by the manufacturing sectors of the market *** [and] producers should [not] incur any

penalty because of price outcomes which... are the result of the order program providing for the advance pricing of Class I and II milk that serves the interest of handlers.” 69 Fed. Reg. 19291, 19300 (April 12, 2004). Ex. ____, p. 3.

Third, we believe that the proposals digress from the central purpose of pooling, which USDA recently reconfirmed, in a legal brief to the 7th Circuit in Chicago, is to prevent “ruinous competition among dairy farmers for the *fluid* market.”

The option of pooling or not pooling milk delivered to a nonpool plant has been a mainstay of the federal order system and it should remain so. Class I prices have for decades been based on the value of milk used in manufactured products, plus a differential. At the insistence of fluid milk processors, regulated Class I prices are calculated and announced by USDA in advance, before the beginning of the month, based upon past manufacturing milk values. Regulated milk prices for manufactured product uses, however, are based on current values and announced retroactively, after the marketing month has passed. This also has been true for decades. Under pricing formulas employed for decades, there is always a lag between changes in the value of milk, and changes in the advance Class I price. As a result, a sharp increase in the current value of milk for manufactured products will periodically produce a Class III (or Class IV) price that exceeds the statistical “uniform” or “blend” price, and on occasion will exceed the Class I price. This has also been true for decades. Exhibit ____, Federal Milk Order Market Statistics for 1989, table 12, for example, shows that considerable milk was voluntarily depooled in nine federal order markets during the latter part of 1988 because the blend price “was at or below the Class III price.”

The occasional inversion of the relationship between Class I or blend prices, and Class III (or IV) values, is caused by advance pricing for milk used in Class I and II products, at the request of fluid milk processors. As a result, regulated producer prices do not reflect the current value of milk in these products. There is good reason to reconsider whether advance pricing for Class I and II products continues to be good policy from a regulatory standpoint. There is a wealth of market information and economic data available to handlers now that was not

available two or three decades ago to help predict raw product values and apply predicted values to future sales of finished products. The recent growth of healthy and vigorous trading at the CME in milk and dairy products, along with non-exchange risk management tools, has greatly enhanced the ability of handlers and producers to manage risks of price variability. Rather than look to remedy the cause of price inversion -- advance Class I pricing, or take an additional step towards letting the marketplace govern, proponents of repool limitations prefer to treat the symptom and further insulate the federal milk order system from marketplace realities. It is time, rather, for Class I handlers to compete for raw milk based on its current value, as manufacturers of Class III and IV products have done all along.

The fact that the federal order pricing system periodically results in Class I prices so low that blended federal order returns are lower than Class II, III or IV prices does not make a case for punishing milk not pooled by limiting repooling. The anti-repool proposals are a bad idea for Order 30. It is a particularly bad idea to consider placing depool-repool limitations in Order 30 when the 'problem' of price inversion and voluntary depooling is national in scope and, as observed by Mr. Kinser, multi-market handlers can readily shift re-pool limited milk to another order. A proposal addressing the same issue is pending for Order 30, and Order 33 interests have also advocated a similar amendment although the latter proposals (Exhibit ____) are not advanced by any handler or 9(c) cooperative under that order.

The federal order formula for Class III milk simply establishes a value for cheese milk based on commodity prices. The Class III price (Class IV if it is higher) has a differential value added to it to determine the Class I price. The differential value (\$2.00 in order 1032) is a legally set, artificially high, subsidized price for milk used in Class I. Cheese milk gets no such subsidy from the federal order because its prices are obtained entirely from the market place. Cheese milk receives no benefit from the federal order unless the money created by the differential value results in a blended value that is higher than the Class III price. That doesn't mean that these producers shouldn't share in Congressionally-mandated enhanced Class I milk values when the blended value is higher than the Class III price.

The Class I price is determined approximately two weeks prior to the month for which it is applicable, using the formula described above and the commodity prices at that time. At the end of the applicable month the final Class III price is set using the same formula. This results in a six week lag between the Class I and Class III price announcements in which the market value can rise or fall, depending on market conditions. For April 2004, the market value of Class III, during this six week period, increased \$6.02 per hundredweight, completely eclipsing the Class I differential value in all markets. This caused the estimated value of the blended federal order return to be substantially less than the estimated Class III price, resulting in most Class III milk being depooled. In effect the federal order created no benefit to the cheese maker because the market value of cheese milk was higher than the subsidized Class I and resulting federal order blended value.

Proponents of Proposals 2 and 6-8 contend that this Class III milk should be penalized by limiting the amount that can be pooled the following month if market conditions warrant. We disagree strongly with this radical change in historical federal order pooling philosophy.

Limiting repooling of milk forces a cheese plant to decide whether it is more cost effective to depool, to remain pooled in order to avoid future limitations or to do a combination of both. In either case, estimating federal order blended values or producer price differentials is not an exact science. Undoubtedly some milk would end up depooled when it should have been pooled and vice versa, causing losses in revenue.

Any pooling of cheese milk where Class III price is higher than the blended federal order return is simply a transfer of money from market driven cheese plant returns to other order participants, whose business leans more toward shipping a higher percentage of their milk to the Class I market. The federal order should be sharing money derived from Class I handlers, not taking money from one group of producers (cheese milk) and using it to offset a low Class I price created by the orders' own pricing system.

Exhibit _____ shows an example of what happens when the cheese values (Class III price) increase dramatically and actually overtake the Class I price during the six week time period from when the Class I price is set and the final Class III is set.

In January '04 a positive PPD is available for all producers because the Class I mover changed very little between 12/19/03 and when the Class III was set on 01/03/04 and created an effective differential between Class I and Class III of +\$2.24. This resulted in a return of 69¢ (PPD) from Class I revenues which should be shared with all milk pooled.

In April '04 the effective Class I differential was negative \$4.02 because of the rapidly increasing cheese market between 03/19/04 and 04/30/04. That resulted in a negative PPD of \$4.11 and caused most of the Class III milk to be depooled. That doesn't mean Class III handlers did anything wrong or took any money they weren't supposed to from the pool, in fact they took nothing from the pool because there was nothing to share. It simply means that Class I values were too low relative to Class III and the return from milk going to Class I (fluid use) was not very competitive with milk used to manufacture cheese. The point is that cheese milk should not be forced to pool or be threatened with limits on what they can pool the following months just because the order pricing system isn't generating enough Class I money to produce a positive PPD.

Cooperatives, government officials and Extension Service personnel, incidentally, must be careful to avoid adding the confusion of many producers that a negative PPD represents a loss or deduction from their milk checks. It is simply an expression of arithmetic for the difference between the Class III price and the blend price. Pooling all Class III milk would not produce a positive PPD when Class I and Class III prices are inverted. Dairy Marketing Services, in its March 2004 newsletter article entitled "Negative PPD is Not Negative," did a good job of describing the negative PPD in a way that would avoid negative thinking. I quote:

Despite what you may think, a very low or negative PPD this Spring does not result in you receiving less money for your milk. The total amount of money generated by the Federal Order marketwide pool is fixed based on the level of commodity prices. The money in the pool can be disbursed to producers via higher component prices and a low PPD, a high PPD and lower component prices, or something in between the low or negative PPD is simply the result of a calculation that is needed to balance the pool. In fact, a negative PPD can be viewed as a positive price signal in that it can only happen when milk prices are rising rapidly.

Arguments that depooled milk is not serving the fluid market or is not available to the fluid market just don't hold water. First, in order to pool milk in any month, a block of milk must be shipping the federal orders' required percentage to a distributing plant or be a part of a unit of supply plants that is doing so. If milk is depooled there is generally no reduction in distributing plant sales because the milk might want to pool again as soon as the next month and the sales will be needed for qualification. Depooling doesn't mean the milk isn't serving the market or that the milk isn't available for Class I use or that the milk isn't as valuable to the market as any other milk, in terms of additional seasonal sales and balancing functions.

Depooling and negative PPD's, which prior to 1996 would have been the equivalent of the federal order blend price minus the Class III price, are not new revelations. Class III prices have been higher than the federal order blended price many times as cheese values rose faster than Class I prices. Exhibit _____ shows the months from 1994 through 1999 when this occurred in old federal order 1079 (Iowa).

Payments from a federal order to similarly located dairy farmers for pooled milk are the same. Farmer milk prices from their milk buyer, however, vary based on the market selected for the producer's milk..

Since I started working with federal orders in the early 1970's, this negative PPD effect has occasionally occurred and depooling was often the result if you estimated that the Class III price was going to be higher than the blend price. When there was Class I revenue to share all milk pooled received its share, added it to their market returns, be it cheese or fluid, and paid producers as best they could. Over this time period there have

been times when cheese was a better return and times when selling to fluid customers was much better than cheese. However, we don't or can't change our business plans for short term advantages and risk losing our customer base. We all compete for producers based on how we have structured our respective businesses.

We fully recognize the competitive problems caused by the federal order Class I pricing structure, however, forcing cheese plants to subsidize the other milk in the federal order pool is the wrong way to solve this problem. The solution, if one is needed, is to price all milk on the basis of the current value of milk. If this is as big a problem as proponents say, it seems that Class I pricing formulas and timing might be a better place to find a solution in order to get the money out of the market place instead of taking it from one farmer and giving it to another. As stated earlier, a national hearing would be a more appropriate way to address this problem.

Proposals 3 and 4 state that if a producer loses association with the order during certain months they will not be permitted to be a producer in that month or future months depending on which month they lost association (including depooling), unless they ship at least ten days milk production to a pool plant during those months.

Creating federal order rules that force handlers to make decisions on pooling or depooling, where it's only a matter of degree which one causes more economic harm, will make federal orders less and less appealing to more and more dairy farmers. I wouldn't want to see more federal orders jeopardized because of issues that have nothing to do with sharing Class I money, as intended. This would be a tremendous set-back to dairy farmer income.

Proponents have asked the Secretary to consider and decide the anti-repool proposals on an emergency basis. This would be entirely irrational. Price inversions and depooling have been with us for decades. It has been a factor in marketing decisions, business development decisions, and regulatory decisions for the course of those same decades. The only difference in depooling between 1991, when DFA and Prairie Farms opposed repooling limitations, and today, is the unusual quantity of price inversion experience last spring. This

difference does not create an emergency. The spring-2004 cow is already out th the barn and way down in the pasture. AMPI and other observers are of the opinion that price inversion is not likely to recur to the degree observed last spring in the near future.