Direct Testimony for Federal Milk Marketing Order Pricing Hearing
American Farm Bureau Federation

Category 3: Class III and Class IV Formula Factors

Submitted September 13, 2023

The American Farm Bureau Federation (AFBF) has nearly 6 million members in all 50 states and Puerto Rico, including many thousands of cooperative and independent dairy farmers. All of these dairy farmers are indirectly or (mostly) directly affected by the pricing provisions of the Federal Milk Marketing Orders (FMMOs).

These dairy farmers play a crucial role in the development of AFBF dairy policy. Every Farm Bureau position and proposal is based explicitly on that policy, developed through a grassroots process in which farmers make the decisions every step of the way.

AFBF submitted 9 proposals for consideration in this hearing and appreciates the opportunity to address the four that were accepted by USDA, as well as the clear direction on what may be needed to advance the rest.

A fundamental focus of AFBF's proposals is the reduction or elimination of negative producer price differentials and the de-pooling they cause. We believe that an orderly pool is the key to orderly marketing and ensuring Federal Milk Marketing Orders continue to benefit farmers, cooperatives, processors, and consumers. The key to an orderly pool, in turn, is, above all, the proper alignment of the four Class prices.

This statement covers Category 3, Class III and Class IV formula factors, and includes AFBF's response to Proposal 7, made by the National Milk Producers Federation (NMPF); Proposal 8, made by the Wisconsin Cheese Makers Association; and Proposal 9, made by the International Dairy Foods Association.

Category 3: Class III and Class IV Formula Factors

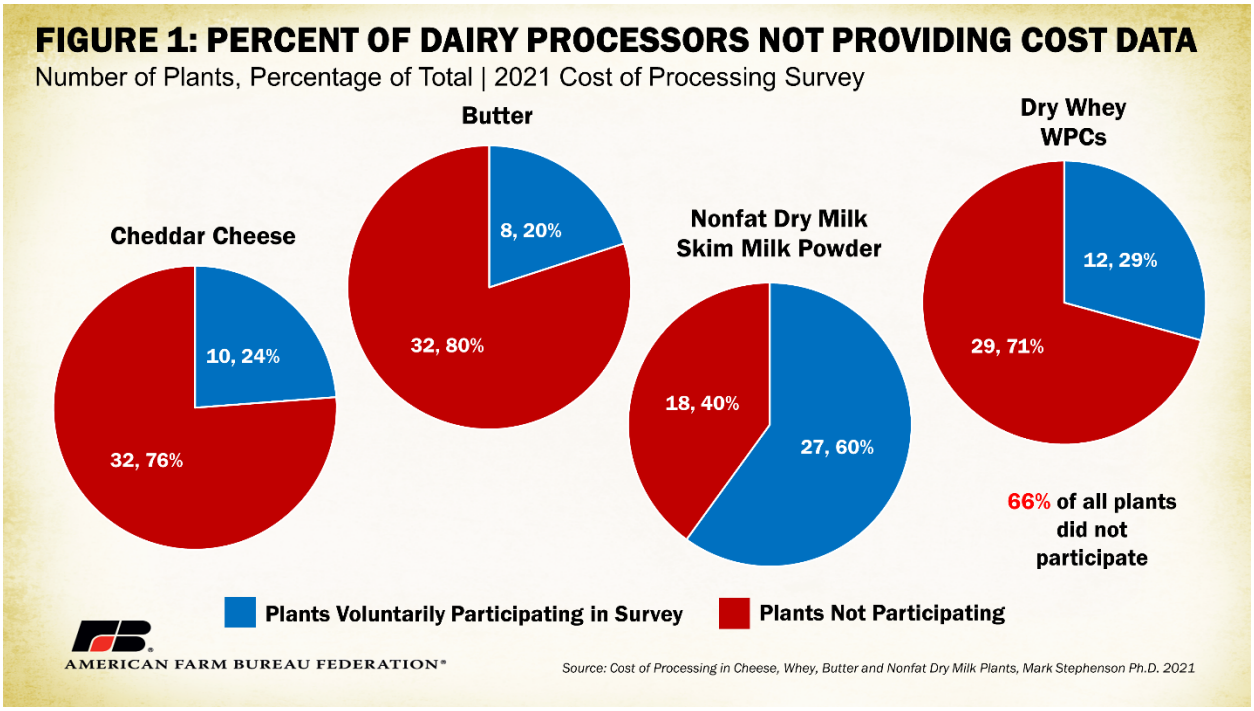
Response to Proposals 7, 8 and 9 (NMPF, WCMA, IDFA), which all propose to increase Class III and IV make allowances.

AFBF supports adjusting make allowances to reflect the changes in cost and technology, following the same general logic as NMPF's petition. We believe, however, that such adjustments cannot be fairly undertaken except using the data from a mandatory and audited USDA survey of, at least, the plants participating in the NDPSR survey.

At the time of order reform, product formula prices were instituted using a combination of a voluntary survey and a mandatory and audited survey. (64 FR 16096, et seq.)

The voluntary survey, conducted by Dr. Stephenson, among others, and used as a primary source for order reform, was one of a series of studies that had been undertaken as a means of evaluating and benchmarking plant costs for the benefit of the plant operators. Because that survey's purpose had not previously been the setting of regulatory parameters, there was no obvious bias in the self-selection of participants. Each participant was, presumably, interested in a full picture of costs, including seeing how they stacked up.

However, more recent surveys, particularly the 2021 update conducted by Dr. Stephenson, was commissioned by USDA with the clear intention of making its results available for proposals to update the make allowance, and its update in 2023 was also explicitly commissioned for regulatory purposes. This, unfortunately, creates an equally clear incentive for dairy manufacturers to be selective in their choice to participate, and an unfortunate temptation to be creative in the accuracy of their reporting. As a result, whatever value the original voluntary survey had for the original development of the make allowances in the price formulas has been substantially undermined by potential bias in the survey. The publicly released 2021 survey, for example, represents only 60% of the nonfat dry milk plants participating in the NDPSR, 29% of the dry whey plants, 24% of the cheddar cheese plants, and 20% of the butter plants. The conclusion must be that it would be unfair to increase the make allowances based on this survey.



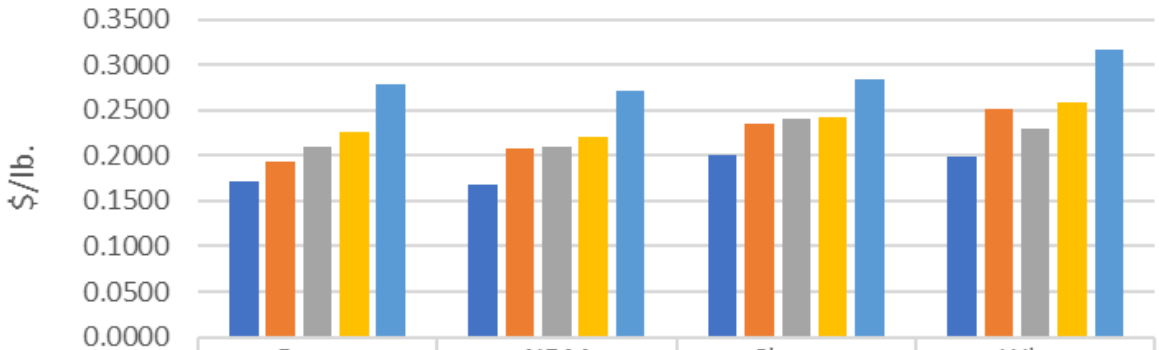
IDFA contends that the 2023 update to Dr. Stephenson's study captures a higher percentage of product plants and volume, therefore nullifying our concerns. Even with the improved sample size, nearly 45% of cheese and nearly 50% of whey volume are still not captured. Our members have expressed ardent concern over plants who elect not to participate in voluntary surveys that are used to inform regulatory decisions. Even small variations in reported cost numbers could lead to make-allowance changes that unfairly substantially reduce the price paid to farmers.

AFBF also has concerns with the projections made by Dr. Schiek on behalf of the International Dairy Foods Association. (See IDFA-2.) The regression analyses used to estimate the source of changes in the "Labor," "Utility," and "Other" costs are based on only 15 annual observations (for 2000 through 2016), which is a relatively small sample size for any regression analysis but especially for equations with 3 to 5 explanatory variables, including the constant term, and is even smaller when multiple specifications have been explored. In addition, the use of dummy variables, which are often applied to explain data in years that the underlying estimation doesn't fit, raises further concerns about the real fit of the regression analysis.

And as problematic as is Dr. Schiek's estimation of the pattern of cost growth within the 15 years of observed data, more problematic is the extrapolation of such results beyond the data period to project costs in 2022. The estimation is to find the best fit within the 15 years, which often leads to parameters that help fit the end years, but often become unreliable when extended to years before or after the study period. A simpler analysis would have been easier to interpret and would have allowed better evaluation of how reasonable the extrapolated results might be. In this case, a relatively complicated model based on 15 years of data is projected out for 6 years, generating questionable results.

Regarding the USDA "tradition" of using two different cost surveys, there is an old saying: "A person with one watch always knows what time it is; a person with two watches never knows what time it is." Such is the problem with using two significantly different sets of survey results and blending them into one result. This is more art than science, and USDA was put in the difficult position of applying such art in the past. It is better that we have one very accurate watch, such as a mandatory and audited survey of processing plants.

Figure 2. Comparison of Makes and Costs



	Butter	NDM	Cheese	Whey
Current	0.1715	0.1678	0.2003	0.1991
CDFA 2016	0.1938	0.2082	0.2354	0.2511
NMPF	0.2100	0.2100	0.2400	0.2300
IDFA 1	0.2251	0.2198	0.2422	0.2582
IDFA Final	0.2785	0.2716	0.2840	0.3172

Sources: Hearing notice (88 FR 47398), Exhibit NMPF-18A
Note: "CDFA 2016 Whey" is CDFA 2016 NDM plus current difference.

The last time we knew the time was in California in 2016 – as the last mandatory audited surveys of U.S. dairy processing costs were those of all manufacturing plants in the state of California in 2016, conducted and audited by the California Department of Food and Agriculture (CDFA). This full accounting of processing costs was a useful component of the overall data used to set make allowances at the time of order reform because California has been the largest milk-producing state since 1993, with over 18% of U.S. production in 2022. It's been the largest butter-producing state since about the same time, with roughly a third of current U.S. production, and the largest nonfat milk-producing state, with 44% of U.S. production in 2022. California is also the second-largest cheese-producing state, with 17% of U.S. production in 2022. Since the 2016 California survey was mandatory, a representative

sample of commodity dairy processors was captured, providing an important check to voluntary surveys. This CDFA survey was discontinued in 2017, after the promulgation of an FMMO in California. (Exhibits NMPF-18A and IDFA-21). Although it did not evaluate product yields, this survey would provide a basis for a conservative one-time increase in FMMO make allowances preferable to those proposed by NMPF or IDFA. These numbers are nearly in line with both NMPF's proposal and with IDFA's proposed initial make allowance increases. (See Figure 2.)

Our conclusion is that any fair update of the make allowances must be based on a mandatory and audited survey of costs and yields at – at least – the plants participating in the National Dairy Products Sales Report (NDPSR). Currently, only the 2016 CDFA survey comes close to this. We at Farm Bureau are working with NMPF and IDFA to pursue language in the upcoming farm bill that would direct USDA to conduct such a survey. AFBF, NMPF, and IDFA all, by their own testimony, hope to have official survey data as soon as is practicable.

Given the continued investment in dairy processing capacity, it is a real question whether the make allowances are too low at all. Moving forward with increases now could easily "go too far."

Handler groups have often argued that they cannot reap the benefits of charging higher prices in the marketplace because those prices get looped into the NDPSR, meaning the make allowance is the only monetary value they can operate off of. This point holds less water when less than 10% of butter, about 10% of all cheese, 28% of whey and 52% of nonfat dry milk volume is captured in the NDPSR. Combined, for the presented commodities, the NDPSR captured 19.6% of total production in 2000, 18.3% of total production in 2011 and 14.8% of total production in 2022 for an average annual decline of 1.1% in total production captured. On average, less than 20% of the total production of cheese, butter, nonfat dry milk and whey have been captured in the NDPSR survey, with a clear decline in the percentage of butter, whey and nonfat dry milk captured. Considering the various other dairy products that are sold and not included in the NDPSR, the true volume of dairy products captured by the NDPSR is likely much lower than 14.8%.

Additionally, a comparison of the 2023 NDPSR survey to the latest National Agricultural Statistics Service (NASS) dairy products survey reveals that 17.2% of butter processing plants, 61.4% of nonfat dry milk plants, 53.3% of dry whey plants and 12% of cheddar cheese plants are captured by the NDPSR survey. In total, 7.2% (a drop from 7.8% in 2018) of all manufacturers that produced one or more dairy products are captured in USDA's mandatory price reporting. This means that more than 92% of dairy processing plants are not required to report the prices for the dairy products they manufacture and sell.

Given these statistics, one could easily argue that handlers can benefit from the sale of the substantial product volume and product varieties not currently captured within the NDPSR and are not exclusively reliant on the make allowance to make ends meet. This is especially true of handlers who diversify their operations, a tactic that many farmers are told to use to protect against revenue uncertainty. This does not mean make allowances are not important, our members recognize they are. But they also recognize the system does not restrict all handlers in terms of covering costs.

Only a mandatory and audited survey of costs (and processing yields) can provide a fair basis for adjusting make allowances (and yield factors) within the current pricing structure, just as it has been clearly established that only a mandatory and audited survey of manufacturers' prices can provide a fair basis for setting the monthly milk and component prices used in the FMMOs.

We believe that such a survey should be conducted once every two years in order to appropriately balance the value of the data with the burden on the processors. This is close to a realistic estimate of the time it takes to undertake an FMMO hearing from petition to implementation; more frequent surveys would be unproductive, although the biannual survey could collect two years of data.

A note on using input price indices: Proposal 9 uses processing input costs to update mandatory audited survey data from California in 2003-2016. AFBF opposes using indexing to adjust make allowances. Over time, input price increases tend to be at least partly offset by productivity increases. This was observed in the record of the 2007 price hearing, in which it was suggested that labor productivity growth, for example, more or less matched wage increases. This is why full plant cost and yield accounting is critical to any fair adjustment of the make allowances.

(See *California Manufacturing Cost Annual, 2016 Data*, California Department of Food and Agriculture, at: https://www.cdfa.ca.gov/dairy/pdf/Annual/2017/ManufacturingCostAnnual2016Data.pdf; NASS QuickStats, annual milk and dairy product production data, see https://quickstats.nass.usda.gov/; Munch, Daniel. Tracking Federal Milk Marketing Order Policy Developments, Market Intel report, April 13, 2023. See: https://www.fb.org/market-intel/tracking-federal-milk-marketing-order-policy-developments; USDA-commissioned 2021 Cost of Processing Study and associated materials: https://www.ams.usda.gov/rules-regulations/moa/dairy/cost-of-processing; Testimony of the National Milk Producers Federation, week of February 26, 2007, Class III and IV price hearing https://www.ams.usda.gov/sites/default/files/media/24statementrogercryanDairy%20Hearing%20Exhibit.pdf; C.J. Morrison Paul, "Modeling and Measuring Productivity in the Agri-Food Sector: Trends, Causes, and Effects" in the *Canadian Journal of Agricultural Economics* (48(2000): 217-240) for an overview of the evidence respecting productivity growth in the food processing industry. https://onlinelibrary.wiley.com/doi/abs/10.1111/j.1744-7976.2000.tb00277.x; *U.S. Agricultural Growth and Productivity: An Economywide Perspective.* By Mathew Shane, Terry Roe, and Munisamy Gopinath, Market and Trade Economics Division, Economic Research Service, U.S. Department of Agriculture. Agricultural Economic Report No. 758. https://www.ers.usda.gov/webdocs/publications/40813/32368_aer758.pdf?v=2589.1); Munch, Daniel. Dairy Products Pricing Report Captures Small Portion of Sales Volumes, Market Intel report, August 31, 2023. See: https://www.fb.org/market-intel/dairy-products-pricing-report-captures-small-portion-of-sales-volumes