Direct Testimony for Federal Milk Marketing Order Pricing Hearing

American Farm Bureau Federation

Category 4: Base Class I Skim Milk Price

Response to Proposals 13 through 17

October 2, 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. Most of these dairy farmers are 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 is, in turn and above all, the proper alignment of the four Class prices, and the relationship between Class I and other classes may be the most important element of that alignment.

AFBF previously testified in favor of our own proposal 18, which would eliminate advanced pricing of Class II skim milk and Class I skim milk and butterfat.

In addition to that proposal, AFBF largely supports National Milk Producers Federation (NMPF) Proposal 13, which would return the Class I formula to the "higher of" the Class III and IV formula, and Edge Dairy Farmer Cooperative Proposal 17, which basically combines NMPF's proposal 13 and AFBF proposal 18.

As context, I will briefly summarize AFBF's Proposal 18, including some comments based on the hearing record to date.

Proposal 18: <u>AFBF proposes to end the advanced pricing of Class II skim milk and components and Class I milk and components.</u>

In AFBF proposal 18, the Class II skim milk price would be equal to the Class IV skim milk price plus the Class II differential. The Class II nonfat solids price would be equal to the Class IV nonfat solids price plus one-hundredth of the Class II differential.

The Class I skim milk price would be the higher of the Class III or Class IV skim milk price plus the Class I differential. And the Class I butterfat price would be equal to the butterfat price plus one-hundredth of the Class I differential.

Advanced pricing and the "average of" Class I price formula are two of the largest contributors to Class price misalignments in federal order markets, leading to negative producer price differentials (PPD's) and milk being depooled, when a manufacturer faces Class III or IV prices that are higher than the market's uniform price. The lag between the announcement of Class I skim milk and butterfat prices and Class II skim milk prices for a month being announced just after the middle of the previous month and the announcement of the other Class prices for a month at the beginning of the following month can create wild divergence between advanced and announced prices in today's volatile dairy markets, as rapid upward swings of Class III or IV prices can put them far above the Class I price. Numerous witnesses have acknowledged that eliminating advanced pricing would help realign the Class prices, and opposed it just because the industry is accustomed to the practice.

Class II advance pricing serves no purpose today: eliminating advanced pricing of Class II skim milk would create a perfect hedge with zero basis risk for Class II milk buyers and sellers using Class IV – and butterfat – contracts. Class II milk buyers are "used" to advanced pricing, as we have heard many times during this proceeding, but many are as capable of handling end-of-the-month pricing as Class III handlers, as they have been, regarding butterfat pricing, for the last 23 years.

This proposal is, fundamentally, a simplification of the system to better preserve the system. Bringing Class I and II prices into temporal alignment with Class III and IV prices will go hand in hand with a return to the "higher of" formula to eliminate most Class price misalignments.

Testimony by multiple witnesses, including from the CMEGroup, suggests that the exchange would be likely to institute Class I futures and options once a need and likely volume is made clear, as the adoption of the "higher-of" proposal alone would do. This is one more reason that this is an appropriate time to eliminate advanced pricing, in connection with other changes to Class I pricing. AFBF is supportive of and engaged in the development of a Class I futures and options complex at the CME Group, to further assist fluid handlers in managing risk. This would be the most convenient outcome for dairy market participants; however, other exchanges could offer these contracts, as CMEGroup does not have a monopoly on agricultural derivatives clearing.

I would note, in connection with the elimination of advanced pricing, that the introduction of Class III/Class IV spread options contracts, in combination with Class III or Class IV futures, would also provide a means for hedging Class I milk.

AFBF believes that disorderly marketing conditions are present when producers do not receive uniform prices because of frequent de-pooling. The current system of advanced pricing contributes to the frequency and magnitude of de-pooling. Given the information and risk management resources available today, AFBF supports announcing prices for all four Classes of milk at the end of the month to which they apply.

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Proposal 13: <u>AFBF supports NMPF's proposal to return Class I base pricing to the "higher-of" the Class III and Class IV pricing formulas.</u>

As NMPF has outlined, the Class I mover based on the 'average-of' Class III or IV has had terrible impacts on dairy farmers and dairy markets when the Class III and Class IV prices have substantially diverged, leading to inverted Class I/Class III price relationships, and resulting in large negative producer price differentials (PPDs) and heavy de-pooling. We believe that changes in the market could lead to similar price misalignments between Class I and Class IV in the near future, as cheese capacity grows and cheese prices fall. For these reasons, we believe that a return to the 'higher-of' formula will be important to maintaining reasonable price alignments and avoiding the chaos of negative draws for Class III and Class IV milk and subsequent de-pooling in the future.

However reasonable it seemed at the time, the mandate to change Class I pricing from the "higher-of" Class III and Class IV pricing formulas has turned out to be:

1) bad for producer revenue, generating Class I prices that were substantially lower than they would have been without the change, and

2) bad for the stability of federal order pooling, increasing the incidence of Class III and IV prices getting out of line with the Class I and uniform prices and leading to unpredictable relationships among Class and uniform prices, depooling, and an undermining of the principle of uniform pricing.

We believe that Class I futures and options contracts will be instituted by CMEGroup, or another exchange if necessary, providing the hedging opportunities which processor representatives have insisted make the continuation of the 'average-of' formula necessary.

We also believe that NMPF has demonstrated the degree to which the 'average-of' formula has put the greater downside price risk on the farmer side of milk pricing, another critical reason to return to the 'higher-of'.

Proposals 14 and 15: <u>AFBF opposes IDFA and MIG's proposals to retain "average of" Class I pricing with a complicated formula to adjust for losses relative to the "higher of".</u>

Both of these proposals are unnecessarily complicated, and do nothing to address the issue of Class price misalignment which it is so important to solve. They are so complicated that they almost seem designed to put the federal order system itself into an absurd light.

The focus of testimony by the proprietary processor groups was on the importance of hedging, for which they justify these Rube Goldberg proposals. Again, we believe that Class I futures and options (or, again, a Class III/IV spread option) would be available in reasonably short order, especially if the industry united in urging CMEGroup to offer such products.

Proposal 16: <u>AFBF opposes the Edge proposal to use the Class III price plus an adjuster as the Class I price mover.</u>

This is another proposal designed to maintain the opportunity to hedge Class I using existing contracts. It is well-intended, and seemed to make sense a few years ago, when Class III promised to be the higher milk price for the indefinite future, as it has been for many years, and as the four Class system anticipated it to be.

However, the supposedly inadequate current cheese make allowances have not, apparently, discouraged cheese plant construction, as has been clear from prior testimony. As a result, there appears to be sufficient American cheese, which has limited export opportunities, on the market so that Class IV, which has an easier export outlet for its products, may tend to be the higher price for quite some time.

In that case, a Class I price tied to the Class III price could operate like a 'lower-of' formula.

The adjustor, which would provide future compensation to the pool for current losses relative to the 'higher-of' formula, is another Rube Goldberg design that delays payment to farmers and does not contribute to proper alignment of Class prices.

We believe, as Dr. Bozic has himself testified, that the CMEGroup will introduce Class I futures and options if advanced pricing is ended; and we believe they will also be responsive to the industry's desire to hedge Class I.

Proposal 17: <u>AFBF supports the Edge proposal to both return the Class I mover to the use of the "higher-of" the Class III and IV price formulas, and to eliminate advanced pricing.</u>

AFBF fully supports Proposal 17, which is effectively identical to AFBF's proposal 18, in combination with NMPF's proposal 13, which AFBF also supports.