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Sept. 10, 2024

RE: Federal Register Doc. No. AMS-DA-23-0031. USDA Recommended Decision: Milk in the Northeast and Other Marketing Areas; Proposed Amendments to Marketing Agreements and Orders; A Proposed Rule by the Agricultural Marketing Service on 07/15/2024

Dear Honorable Secretary, AMS administrator, Deputy Administrator, and Hearing Clerk

American Dairy Coalition is a grassroots organization headquartered in Green Bay, Wisconsin, representing dairy farmers nationwide. The ADC board is currently made up of dairy farmers from five Federal Milk Marketing Areas – Northeast, Southeast, Mideast, Central, and Upper Midwest, with members and outreach including those from other milk marketing areas as well.

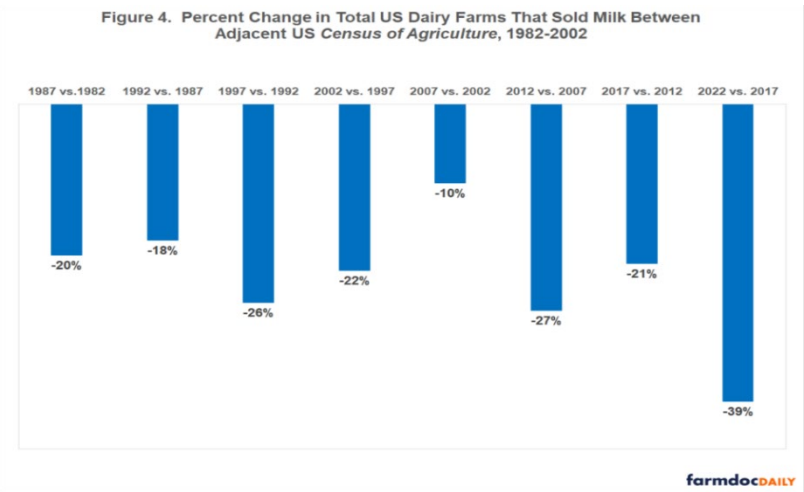
We respectfully request reconsideration or modification in three areas of the Recommended Decision on Proposed Amendments to Federal Milk Marketing Orders.

If the COVID pandemic disruptions have taught us anything, it is that dairy systems need to be resilient, transparent, and support fair pricing policies that positively impact dairy farms, the economic vitality of the rural communities that depend on them, and the regional food systems that are essential to American food security.

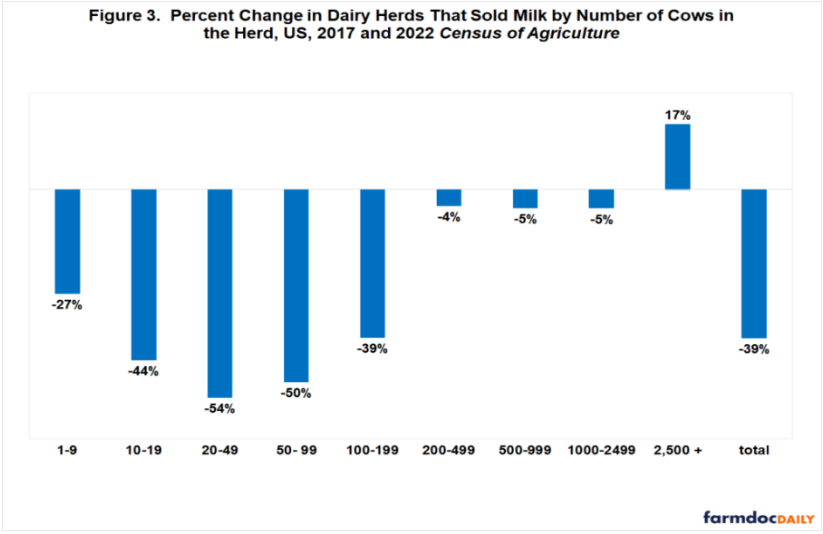
The justifications we present here are rooted in the purposes of the Federal Milk Marketing Orders described as follows in a June 15, 2022 *Congressional Research Service* bulletin, page 2:

> *"According to testimony USDA provided to the House Committee on Agriculture in 1979, the objectives of FMMOs are as follows:*
>
> - *Promote **orderly marketing conditions** in fluid milk markets,*
> - ***Improve the income situation** of dairy farmers,*
> - *Supervise the terms of trade in milk markets in such a manner as to achieve more **equality of bargaining** between producers and milk processors, and*
> - *Assure consumers of **adequate supplies of good quality milk** at reasonable prices.*

American Dairy Coalition represents dairy farmers of all sizes. According to USDA, 89% of dairy farms are likely to be small businesses based on the 2022 Census of milk cow herd inventory and sales. We understand regulatory changes are evaluated for impact on small businesses, which USDA defines for dairy farms at a $3.75 million per year income limit to establish an annual milk marketing threshold of 18.3 million pounds, excluding additional monies received by dairy producers. Based on the 2023 average yield per cow and NASS average All-Milk price, a dairy farm with approximately 780 cows or fewer would meet this definition, according to USDA.



The 2022 Census of Agriculture showed the total number of farms with milk sales (mainly small businesses) declined to 24,470 vs. 40,336 in 2017, and USDA reports 19,576 of them had milk regulated on an FMMO for at least one month of the year. This -39.4% decline between the 2017 and 2022 Census was the largest decline – ever -- dating back to the 1982 Census (Fig. 4), according to a paper jointly authored by Ohio State University economist Carl Zulauf and Illinois State University economist Gary Schnitkey.



"Large percentage declines in US dairy farms have been an on-going story, **but the most recent decline stands out,"** the economists observe. They also point out "fewer U.S. farms sold milk in 2022 than in 2017 at all herd sizes except those with 2,500 or more cows (Fig. 3). The latter increased from 714 to 834 farms, a gain of 17%, while all other herd sizes (mainly small businesses) fell dramatically. Furthermore, the authors note the 2,013 largest dairy farms in the U.S. accounted for 66% of the milk supply -- up from 53% in 2017.

A major chunk of this five-year loss of dairy farm small businesses between the 2022 Census and 2017 Census includes the first three years in which the average-of method (plus a 74-cent adjuster) has been used to calculate the skim portion of the Class I base price mover instead of the higher-of method, which had been used Jan. 2000 through April 2019.

The linchpin to regional dairy systems and markets for milk from farms that fit USDA's description of small businesses is the processing of fresh, conventionally pasteurized (HTST) fluid milk, procured within a larger radius of existing plants today, but still the freshest, most regionally local, minimally processed food found year-round in supermarkets.

Processors are making big bets that consumers will embrace the obvious conversion to extended shelf life (ESL) processing that is underway, accelerated by the 2019 Class I mover change to the average-of. ESL processors testified that this allowed them to use Class III and IV hedges on the CME to offer flat long-term (9-to-12-month) pricing to customers, and their sales increased. Many of the new ESL facilities make other beverages, including plant-based from the same location. Meanwhile, fresh HTST milk plants have seen minimal investment and increased closures since 2019, except for Walmart's new HTST plants underway in Georgia and Texas.

I. Request for scrutiny and modification of the surprising proposed two-mover Class I pricing system, which would create a new class of milk that was not defined or vetted in the hearing.

American Dairy Coalition respectfully asks USDA to reconsider, or at a minimum to modify its proposed two-mover system for Class I. We are concerned about the procedural deficits that have added an undefined fifth class of milk and precluded the study or presentation of evidence on potential impacts of splitting and further complicating Class I pricing with a second mover based on a vague application of shelf life with no vetted parameters. ***We believe – at a minimum -- further study and a vetted definition and parameters with a built-in review process are needed.***

We appreciate that the recommended decision restores the higher-of method for establishing the primary Class I mover after the overwhelming volume of testimony about the disorderly markets and cost to dairy farmers when the 2018 farm bill change was implemented changing the Class I mover from higher-of to average-of (with a 74-cent adjuster).

However, we are concerned about the last-minute introduction of a second mover for ESL fluid milk products -- after the hearing concluded. This part of the Recommended Decision adds a new undefined class of milk. We find no definition or discussion of a definition in the hearing record.

The proposed second mover for ESL milk uses a rolling adjuster that aims to gradually restore potential losses over 24 months with a 12-month lag but does so without a vetted definition for this new class of milk, nor any examination during the hearing of the potential unintended consequences in creating this new and **undefined fifth class of milk.**

USDA could address our concerns by:

1) Defining this new class of milk and the qualification parameters in a rulemaking hearing.

2) Narrowing the scope or implementing the second mover on a trial basis while the definition and parameters of the class are vetted through a rulemaking hearing.
    a. This will be a tall task because ESL covers a wide and growing range of products. The only parameter mentioned in the Recommended Decision is a 60-day shelf life. Where did that come from? ESL is a term industry uses for everything from 30 to 90 day refrigerated milk to the 6 to 12 month unrefrigerated milk.

3) Requiring Class I fluid milk products that meet a specified ESL definition – once vetted -- to remain in that designation to avoid opportunistic movements between movers that could reduce payment obligations.
    a. USDA's own data show the ESL adjuster, based on static analysis, would have ranged from $1.18 per hundredweight above to 95 cents per cwt below the established monthly higher-of Class I mover in 2023. That is a large and volatile spread between two movers, producing quite different fluid milk costs from the same plant location at the same time – based on as yet to be defined shelf life.

4) Building-in an automatic review process to occur within two years of implementation to review and evaluate potential unintended consequences of this proposed two-mover system.

5) USDA and the industry could also work with CME to develop a Class I futures contract based on the higher-of method so that producers and processors could manage Class I price risk without this complex and undefined second mover.

One of the biggest justifications for our request is procedural.

The Milk Innovation Group (MIG), in their March 7, 2024 letter, objected to the American Farm Bureau request for an emergency decision on the higher-of, citing many procedural issues should the Administrative Law Judge and USDA Secretary even consider the Farm Bureau request. MIG stated:

> ***"The volume of evidence and complexity of issues at the hearing, coupled with the diverse views of the various participants, counsels that the full hearing process must be followed in this matter."***

These words ring true for USDA's proposed two-mover system as well. The full hearing process must be followed in the matter of bringing an unprecedented fifth class of milk into the amended pricing formulas -- after the 49 days of proceedings have concluded and without opportunity to vet the concept in the hearing.

A second justification is different movers, calculated differently, will result in different Class I raw milk product costs between processors at the same location. This was not examined in the hearing, nor were the parameters examined for defining ESL -- considering the industry does not yet have an exact and generally-accepted definition for ESL in the first place.

In fact, ESL is both a loose and specific term. Generally speaking, it is used to cover a broad range of products -- from UHT (ultra high temperature) or ultra pasteurization, aseptic packaging, to the inclusion of a process that combines microfiltration, skim separation, and indirect heating, in stages, to produce what is more specifically referred to as ESL fresh milk with a longer shelf life in refrigeration, but not shelf-stable.

A third justification is the volume of testimony, including a vast majority of dairy farmer testimony, detailed the negative past and current experiences of disorderly markets while average-of pricing has been in play – apart from the monetary losses.

In the Recommended Decision, USDA notes that ESL represents 8 to 10% of total fluid milk sales but does not present the full picture of how the industry began aggressively converting to ESL since 2019, with accelerated investments becoming operational 2023-26.

One third (11) of the 32 new plant investments highlighted on the IDFA map (below) are fluid milk – all of which are a combination of ultrafiltered and ESL or simply ESL and/or aseptic bottling investments, except for the Walmart plant under construction in Georgia, which has been indicated as an HTST milk plant. Some of the new ESL plants will bottle both dairy and plant-based beverages. This map does not include the many other investments in ESL, nor the existing ESL facilities that have expanded 2019-23.

In addition to the 10 new ESL plants that range in ownership from cooperative to proprietary to supermarket-owned, at least 12 existing ESL plants are owned by cooperatives; three are operated by fairlife; and there are others.

Before we know it, the industry will have converted to ESL, and dairy farmers will once again experience disorderly marketing, depooling, and the basis risk of the average-of mover.

Dairy farmers have seen this movie before. In 2018, the average-of method was portrayed as revenue neutral, but farmers experienced Class I revenue losses totaling nearly $1.3 billion from May 2019 through July 2024 and other impacts. Disorderly markets via the average-of continue to result in losses and disrupt performance of risk management tools that failed to protect farmers against the intervals of extreme basis risk -- not just during the COVID pandemic food box program but in several periods thereafter, as well as before the pandemic in the fall of 2019.

Proponents say the proposed rolling 36-to-13-month ESL adjuster on the second mover in the Recommended Decision provides compensation to farmers for the difference between average-of and higher-of. However, it does this gradually -- over time -- and with a lagged interval to protect CME formulas used in risk management.

However, this does not solve the cash flow and disorderly marketing concerns of farmers at the time of an extreme price spread.

Bryan Henrichs, an Illinois dairy farmer, testified on Sept. 19:

"The problem with 'rolling adjusters' is they try to make up for these losses, later. They don't help much if the large losses — the large negative basis that can't be managed — hits cash flow so hard that farms are out of business by the time it's 'made up' to them … gradually. I know some dairy producers that needed that money at that time — not 12 to 18 months later. I know of some that are no longer in business when they received the (PMVAP) payments. The higher-of will ensure that the dairy producer is compensated at the time of the sale instead of later…"

Henrichs pointed out that risk management doesn't help in this scenario because *"Disorderly marketing that occurs when Class I is priced below a manufacturing class, leads to depooling, which disrupts how risk management functions. So, even though on the Board of Trade, they may have looked good, that's not what we received on our dairy farms."*

AMS Deputy Administrator Erin Taylor asked Henrichs if this was because the Class III milk wasn't pooled in the time period he was referencing.

Henrich responded: *"Yes, In Order 32 only 6% of Class III milk was pooled that month, so our price was around $12 to $13 per hundredweight for our dairy farms, but the contract for ($18) was set to pay but did not because of that $20 Class III price on the Board of Trade (which became the announced FMMO price that led to Class III depooling)."*

A fourth justification is a deeper dive into risk management. Processors contend the average-of method is necessary for them to manage price risk using Class III and IV milk futures. The hearing record shows that this applies mainly to ESL and aseptic fluid milk products. HTST milk, with 6-to-17-day shelf life, is a fresh product with fast turnaround and already advance priced.

A representative for Nestle, the largest ESL and aseptic milk processor globally testified that their sales, such as for single-serve Nesquik, increased after the May 2019 implementation of the average-of because they could offer long-term 9- to 12-month flat pricing to buyers to secure shelf space, which they said is what non-dairy beverages reportedly do.

A representative for fairlife said that without the average-of method to hedge their long-term price risk by using Class III and IV contracts on the futures markets, the size of their future expansions would be at risk.

Would it not be prudent to work with the CME to develop a Class I futures contract and options based on the higher-of, which would offer both producers and processors a method to manage their price risk without the impacts of disorderly marketing and depooling? Such an option was not pursued by the industry, but it was brought up in the hearing.

> On August 28 (transcript page 803), Roger Cryan for American Farm Bureau cross examined Anne Knemma, testifying for the CME. He asked:
>
> > *"… When Congress made a change to the Class I price formula, it was in order to accommodate risk management by fluid processors so they could use the Class III and the Class IV contracts that exist to manage their risk on the Class I price in ways that were difficult to do with the higher-of. You have added contracts in the past. You have added the block (cheese) contract. Is it not a possibility to add a Class I futures contract?"*
>
> She responded:
>
> > *"We're always open to engagement with the industry on additional tools to suit the industry's needs. You know, I'm not going to speculate anything out of this hearing, but in general, we're always open to feedback if there are additional tools needed to manage risk."*

A fifth justification is the ESL rolling adjuster -- as a second mover -- introduces more complexity to the FMMO pricing system, making it less transparent and more vulnerable to volatility and unintended consequences.

Processors will know 12 months in advance what the ESL adjuster will be. Since the recommended decision continues 'advance pricing' for the Class I mover(s), processors will know the higher-of and average-of to do the math in the middle of the month preceding their collection of milk from dairy farmers. Meanwhile, the settlement prices paid to farmers for a month's worth of milk shipments will continue to be ultimately determined two weeks after processors report to Market Administrator what they did with the pooled producer milk -- which classes of products (and perhaps which Class I mover) applies to how that milk was utilized, determining the pool values and minimum price.

This could mean additional disorderly marketing between movers and between plant costs, even at the same location. It also contributes to volatility and opportunistic depooling by continuing the incentive for wide spreads between Class III and Class IV.

Will consumers embrace the taste of ESL and aseptic milk, or migrate faster to other beverages if fresh fluid milk is less available to them?

Would a two-mover system enhance and accelerate a conversion of the dairy industry that puts farmers right back into disorderly marketing scenarios? Could this reduce farmers' access to milk markets in some regions and diminish the food security of those consumers? How will the two-mover system impact dairy farms located outside of the industry's very specific identified growth centers?

Is it within the purview of the FMMO amendment process to formulate a split-decision for Class I that has not been examined in the rulemaking hearing process, and which adds a new class of milk without a vetted definition?

II. Request for reevaluation of proposed make allowance increases

American Dairy Coalition respectfully asks USDA to reevaluate the proposed make allowance increases in the USDA Recommended Decision:

Updates to the processor make allowance credits can only be accomplished fairly in today's modern dairy industry when the plants that report sales to the mandatory USDA AMS weekly National Dairy Product Sales Report (NDPSR) also report to a mandatory and audited cost of processing survey. The NDPSR prices are used in the product pricing formulas that subtract a 'make allowance' for each of the four base commodities that establish the two-week advance fat and skim pricing factors (Class I) and four-week announced class and component prices (Classes II, III, IV).

According to USDA data assembled by American Farm Bureau, the NDPSR captures only 14.8% of the cheese, butter, nonfat dry milk and whey product sales, down from 26.5% in 2002, and the participation in the 2022 voluntary cost of processing survey was 50 to 55% for Class III products (cheese and whey), but 80 to 90% for Class IV products (butter and nonfat dry milk), which tells us something about the widening spread.

USDA could address our concerns by:

1) Basing make allowance updates on more complete and audited data from mandatory, audited cost of processing surveys from at least those plants that are reporting sales of the four base commodities used in FMMO product pricing formulas. The voluntary s

2) At a minimum, significantly reducing the proposed make allowance increases – until such mandatory and audited cost of processing surveys are implemented, especially on Class III products, which had just 50 to 55% participation in the voluntary cost of processing survey, for reasons detailed herein.

3) Tethering increased make allowances to a plan by USDA to require more transparent milk checks for both cooperative and non-cooperative member dairy farms, including minimum component values in pooled producer payments, not just the gross regulated minimum price.

4) Reconsider the size of the increase in the whey make allowance relative to its smaller price level and implement a floor or 'snubber' to prevent negative other solids values for reasons detailed herein.

Justifications for Nos. 1 and 2

The last time the make allowances were raised in October 2008, a dairy crisis followed. One can only imagine the risk dairy farmers face if the steep increases in these processor credits currently proposed by USDA would be implemented in early 2025 during a time of great economic uncertainty in the U.S. and globally.

In hearing testimony, National Milk Producers Federation (NMPF) has asserted that the collective impact of all four proposed make allowance increases by IDFA -- which USDA has come close to or exceeded in its recommended decision -- represents a $1.42 reduction in the average All Milk price, overnight.

For many farmers, $1 to $1.50 per hundredweight can be the margin of difference between survival and exit in many of the last 10 to 15 years, and it disrupts the capability for their reinvestment in their businesses.

Of the plants making the products that are reported in the weekly National Dairy Product Price Report (NDPSR) used in product price formulas, only nonfat dry milk (91%) and butter (80%) had a participation level above 55% in the Stephenson Cost of Processing Survey done in 2023 using 2022 data.

Class III products, on the other hand, had far smaller participation, but resulted in larger make allowance increases.

Cheddar cheese production represented in the voluntary survey was only 55.6%, and dry whey was 50.1%! This tells us something about the spread we see growing between Classes III and IV as product price reporting volume, as well as the percentage of voluntary cost of processing survey participation are much smaller and less transparent on the Class III side than Class IV.

Make allowances are set per pound to represent specific non-milk costs in transforming milk into the four base commodities that are price-surveyed in the AMS weekly National Dairy Product Sales Report (NDPSR) for the FMMO product pricing formulas – cheddar cheese, butter, nonfat dry milk and dry whey.

According to American Farm Bureau, the NDPSR captures less than 15% of the sales volume of these products and does not even account for all of the non-surveyed dairy products that have increased in sales volume over the past 10 to 15 years.

In fact, Dr. Mark Stephenson noted in his description of the 2021 voluntary cost of processing survey that **it was much more difficult to "extract" just the costs related to the four commodities** used in product pricing formulas due to the size and complexity, as well as innovation, of today's dairy processing plants.

Today's plants make a wider range of products. **These other products -- that are NOT price-surveyed by USDA -- represent substantially more milk** and may be sold at higher prices that are not fed back into the product pricing formulas, so they don't influence the regulated minimum prices paid to dairy farmers.

This may allow for additional income to cover processing costs, and it demonstrates why mandatory, audited cost of processing surveys are necessary to make sure cost-reportings are appropriately allocated between price-surveyed and non-surveyed products made in the same plant.

In his hearing testimony in IDFA Exhibit 1, page 11, Dr. Mark Stephenson states:

> *"…. although the author (himself) has never had reason to doubt the integrity of data submissions,* ***the voluntary process does not carry audit authority to verify unusual cost observations*** *in plants. There are several built-in cross-checks with the data collection which can highlight unusual data. Often a follow-up call to the participating plant will fix an entry mistake, but verification is not possible.* ***As plants have become much larger and much more complex, attribution of costs to products has become more difficult. The industry must insist that care and thought be applied to cost collection and summary if these values are to be used in product price formulas. Accurate representation of costs is important to both milk producers and plant owners.*** *Cost reporting should also be conducted on a regular and not ad hoc basis."*

The auditing component is essential to ensure no bleedover of costs from non-price-surveyed products into the data provided so that only the costs to transform milk into the four base commodities is included and not expanded to include broad, nebulous, indirect 'costs' such as 'sustainability', which was mentioned by representatives for IDFA as costs they want included, that they say cannot be retrieved from the marketplace. This is debatable.

Farmers even question the inclusion of average return on investment representing 7 to 14% of the transformation costs in the Stephenson survey – something dairy farmers can only dream of having covered consistently in their thin to absent margins during many of the past 10 to 15 years. Proof of the pudding is the 2022 Census of Agriculture documenting a record large five-year decline in the number of farms with milk sales, down 39.4% in the 2022 Census vs. the 2017 Census (Fig. 4, page 2).

IDFA detailed in their post-hearing brief that,

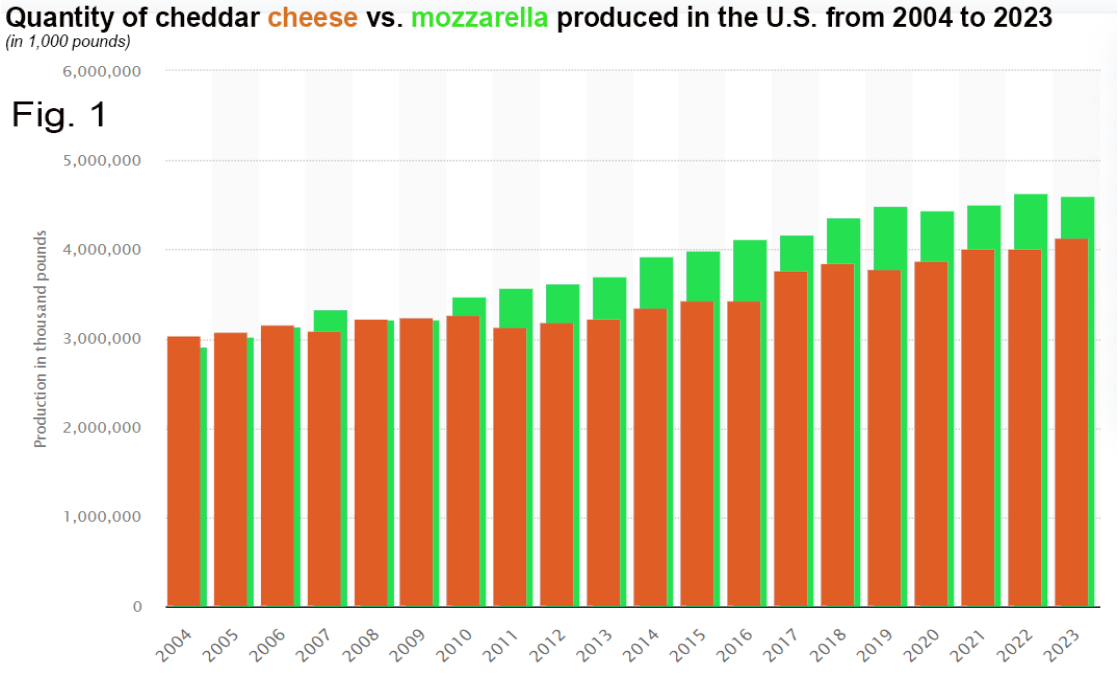
> *"The product pricing formulas "trap" dairy product manufacturers into fixed make allowance with no opportunity to cover their higher costs no matter the price of their dairy products."*

How trapped are processors? Again, according to American Farm Bureau, less than 15% of the cheese, butter, nonfat dry milk and whey product sales are captured in the NDPSR, which means more than 85% of the unsurveyed products in these four categories -- as well as many other products outside of these four categories, such as Class I and II products -- are not surveyed, and thus are not trapped. Processing costs can be recovered in downstream pricing instead of back-charging farmers upstream.

Proposals seeking to add products to the NDPSR were rejected by USDA.

The Recommended Decision removes 500-pound barrel cheese from the NDPSR and by extension the product pricing formulas, but also rejects American Farm Bureau's proposal to add 640-pound block cheddar.

Today, processors make more Mozzarella than Cheddar (Fig. 1).



USDA rejected California Dairy Campaign's proposal to add a price series for mozzarella to the cheese price formula, stating no evidence was presented to define a commodity mozzarella product, rather than a value-added product, constituting a standardized market clearing product.

It's worth noting that in Feb. 2024, bulk mozzarella was added to the 'market clearing' Global Dairy Trade (GDT) biweekly internet auction. In July 2024, USDA AMS issued Draft Commodity Specifications for Bulk Mozzarella as well.

Today, processors make a growing amount of bulk unsalted butter as well, but USDA rejected American Farm Bureau's proposal to include bulk unsalted butter in the price survey and product price formulas.

Today, processors make a range of milk powders, including skim milk powder, which has a uniform protein composition, unlike NFDM. Other powders include whole milk powder, buttermilk powder, and a range of milk protein concentrate and milk protein isolates that are also not price-surveyed. In 2024, we have seen the production of NFDM decline by 10% year over year (YOY), while whole milk powder production is up 25% YOY and the production of MPC and MPI have increased by more than 70% YOY.

Today, processors do not just dry the whey, they make a range of other products, including whey protein concentrates and whey protein isolates used in a variety of high protein beverages and bars as well as other foods and snacks. They also make pizza cheese, a unique whey cheese that is a second curding of the whey byproduct of the cheesemaking process. In 2024, we have seen the production dry whey production for human use fall 25% YOY, while production of WPC is down just 6% YOY and WPI production is up 30% YOY. In fact, combining WPC and WPI production, the totals are running 85 to 90% as large as dry whey production totals, and there are the other whey products that are not NASS surveyed for production totals.

These are some of the most obvious examples of how dairy innovation has reduced the 'hamster-on-a-wheel' scenario of processors raising prices to cover costs and then feeding those increased sales prices back into formulas that set prices paid to farmers without enough margin deducted to operate. The unreported products often made at the same plants as the four base commodities are NOT reported in the NDPSR, meaning they are not fed into the product price formula 'hamster-wheel.'

Justifications for Nos. 1, 2 and 3

Referenced in IDFA testimony is USDA's proposed rule language back in 1999:

> *"The importance of using minimum prices that are market-clearing for milk used to make cheese and butter/nonfat dry milk cannot be overstated. The prices for milk used in these products must reflect supply and demand and must not exceed a level that would require handlers to pay more for milk than needed to clear the market and make a profit."- Federal Register /Vol. 64, No. 63 / Friday, April 2, 1999 / Proposed Rules 16095*

Representatives for Leprino testified to this, stating that current make allowances are too low, leading USDA to set regulated minimum prices too high – above 'market clearing' levels. Processor testimony indicated they can't pay the minimum prices and make a profit, and they have lost the ability to pay producer premiums.

And yet, during the hearing, when testifying on a MIG proposal regarding Class I fluid milk, Dr. Mark Stephenson's MIG Exhibit 16B showed on a map the intensities of color which were then amended and re-introduced (covering areas where Leprino has plants by the way). The map was built from the USDSS model that moves milk to its highest value use. He said:

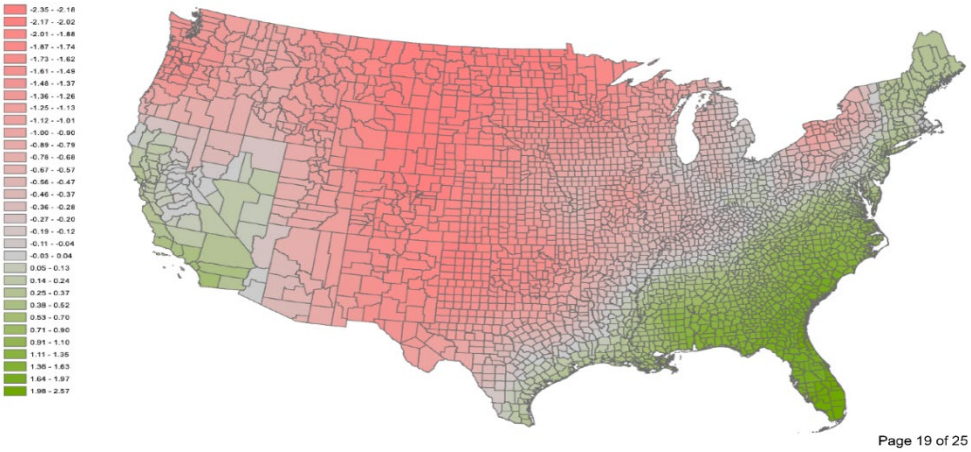
> *"Delivery of milk to a cheese plant is of more value to the overall market. A fluid plant located in a red colored region of the map would find that cheese plants in the area were* ***unwilling to give up milk unless you compensated them for at least their opportunity costs which are greater than the fluid plant's marginal cost of milk."***

He tested his own idea that the $1.60 base differential could be kept by Class I processors (instead of being pooled) to pay directly to those serving the Class I market. (Class I processors already receive the make allowance credits built into the advance skim and fat pricing factors that are used to set the Class I mover(s.) Dr. Stephenson showed the model-derived map (Fig. 3, MIG Exh. 16B), and said:

> *"The US average value of these differences was -$0.38, indicating that on a national average it is more valuable (cost saving) to the model to have milk in a cheese plant than in the fluid plant in most US counties. The range goes from somewhat more than $2 per cwt more favorable to a cheese plant (in red) to somewhat more than $2 per cwt more favorable to a fluid plant (in green) in the Southeast. Milk use for manufactured dairy products cannot be ignored. They have a geographic basis just like fluid milk does. And, in many locations* ***they can out-compete fluid plants*** *for the local milk supply."*

MIG Exhibit 16B

Figure 3. Difference in the Marginal Value of Milk in Class I Minus Class III Plants.



How can both claims be true -- that regulated minimums are set too high (because make allowances are set too low) at the same time that cheese manufacturers can out-compete fluid plants for local milk supply? Are Class III processors truly 'trapped' on the hamster-wheel?

In terms of 'market clearing' prices, another contradiction is occurring in the NDPSR price survey of dry whey, the make allowance that received considerable testimony, especially from Leprino representatives in relation to the new Lubbock, Texas plant. As cheesemakers, they also make whey products, including 'pizza cheese,' which is a second curding process of the residual whey stream.

In the uptrending whey market of the past three months (June-Aug 2024), the dry whey price reported by processors in the weekly USDA NDPSR – the price used in the FMMO product pricing formulas -- is lagging the 'market clearing' price on the CME daily spot market by a 7 to 10 cents per pound margin. Even after 30 days, the CME spot is not translating to the NDPSR by this considerable margin.

Justifications for No. 4

USDA's recommended decision would raise the dry whey make allowance by the largest amount for the smallest of the four base commodity prices from the current level of $0.1991/lb to $0.2653/lb. That is nearly a 7 cents per pound (33.2%) increase.

This is too large, especially given the mere 50% participation in the voluntary cost of processing survey when it comes to dry whey production. There are real concerns in setting this one too high without better participation.

At $0.2653/lb, the proposed whey make allowance is well over half the NDPSR price of dry whey every month this year, including the past three months in which the 'market clearing' spot price for dry whey on the daily CME cash market in a $0.50 to $0.60 per pound 'market clearing' trading range has failed to transfer to the NDPSR, which is stuck at $0.44 to $0.49 per pound.

Part of the reason for this is that dry whey production is declining as the production of the valuable non-price-surveyed whey products is increasing.

Dairy farmers helped fund the research and development for several whey product innovations, including 'pizza cheese' through their mandatory dairy checkoff. They have been told that such innovation will help the industry grow and utilize more whey byproduct, which would push the dry whey commodity higher.

Instead, the NDPSR price used in the FMMO product pricing formula lags the market clearing spot price on the CME by a consistent 7 to 10 cents over the past three months of this currently uptrending market.

And, in a downtrending market, dairy farmers run the risk of giving their other solids away or paying processors to take them.

This is because there is no floor to stop producer losses at zero when the NDPSR whey price falls below the proposed whey make allowance.

For example, had the $0.2653/lb whey make allowance been in effect in 2023, it would have been at or above the NDPSR dry whey price in July and August 2023. At a 1.03 dry whey yield per pound of other solids, each penny or fraction of a penny the NDPSR whey price is below the whey make allowance equates to approximately that same number of pennies or fraction of a penny in negative value per pound of other solids in pooled producer milk.

Dairy farmers would have given away the other solids in their milk – free – or paid processers to take these solids, even though they have value in all of these other unsurveyed products that contribute no value to their milk checks through the product price formulas, and that they helped pay for the research and innovation through the mandatory dairy checkoff.

This also happened for seven straight months ranging as much as a 4-cent negative value per pound of other solids the last time make allowances were raised in October 2008 through April 2009.

Justification for No. 3

ADC has witnessed disingenuous use of premiums within pooled producer milk check calculations that are not transparent and demonstrate how earned premiums (such as for protein) can be set forth in one area of pooled producer milk checks, but then carried over and used to make up for underpayment of the other solids minimum price to yield a gross payment that meets a pooled producer's individual and unique regulated minimum payment, which is typically higher than the Market Administrator's published standardized uniform price (SUP), because the SUP is based on 3.5% butterfat.

Most dairies today make more than 3.5% butterfat. The national average in 2023 was 4.1% BF, and so far in 2024, the national average is 4.2% BF. When farmers see their gross payment converted to a per-hundredweight price that is above the published SUP, they often believe their premiums were received or that their basis is better than it actually is. They may not realize this overage is comprised of any positive difference in location differential vs. the SUP, adjustments for SCC in four Orders that do this, and payment for the actual butterfat pounds above the 3.5% standard per hundredweight of milk, which for processors means more pounds of product to sell per hundredweight of milk.

Thus, as dairy farmers become more efficient and productive to survive and get ahead, the invisible hand pulls this back toward the regulated minimum by robbing from Peter on one side of the milk check to pay Paul on the other side – and Joe Farmer meanwhile is often none the wiser.

Additional relevant information regarding make allowance levels

The Class III make allowances for cheese and whey currently total $3.17 per hundredweight, and the Class IV make allowances for butter and nonfat dry milk total $2.17. The American Farm Bureau reports that a static analysis of the impact of the proposed make allowances if in place 2019-23 would have averaged an 81 cents per hundredweight reduction in the Class I price, 74 cents per cwt reduction in Class II and IV and 89 cents reduction in Class III.

The current make allowance levels already build in a $1.00 per cwt spread in favor of Class IV. With the proposed increases, this regulatory spread grows to $1.15 per cwt, on average, and as much as $1.50 per cwt under some marketing conditions, such as depooling when divergences occur, which is in part stimulated by such divergence in the first place.

This is another reason care must be taken to base modern make allowance levels on modern dairy processing conditions using complete data via mandatory audited cost of processing surveys.

Investment for the future

In its post-hearing brief, IDFA states that,

> *"The 2023 Stephenson study and the 2022 Schiek study reflect real costs and make allowances at any lower-level cause dairy processors to face financial losses, risk financial ruin, and/or lack appropriate financial incentive either to re-invest in their plants or build new plants at a proper level. If manufacturers attempt to raise their product prices to cover higher costs, those higher prices automatically lead to higher milk prices, leaving no additional net income to apply to the higher costs." (IDFA Exhibit 6, page 24, testimony of M. Brown).*

This description of the hamster wheel leaves out the multitude of unsurveyed products made today as already discussed.

Meanwhile, dairy farmers face many of the same cost increases as processors – energy, fuel, labor – to name a few. **USDA's proposed make allowance increases are more than twice as large as any in the past** -- at a time when dairy farmers are told to deal with their own rising costs by increasing their efficiency. Aren't processors doing this also?

While dairy farmers continually hone their management to improve cash flow to sustain reinvestment in their businesses, we see that the processing sector has $7 billion in new investments coming online 2023 through 2026 (see map, page 3).

> USDA notes in its Recommendation: *"Opponents of increasing make allowances argue a number of points— that they are already set at too high a level, that dairy farmer production costs also have increased significantly due to higher energy and feed costs, that processors should look beyond asking dairy farmers to receive less for their milk by charging more for manufactured products, and that make allowance increases should be made only when all dairy farmer production costs are captured in their milk pay price. These are not valid arguments for opposing how make allowances should be determined or what levels make allowances need to be in the Class III and Class IV product pricing formulas."*

The justification for our requests are not rooted in dairy farmer economics, although the purpose of the FMMOs and the contrast between reinvestment in the processing sector vs. the dairy farming sector at this time are important considerations in terms of market power.

In Summary regarding the proposed make allowance increases

1) The product volume captured in the NDPSR is quite small and declining (14.8% in 2022 vs. 26.5% in 2002). This is a signal that innovation affords processors a greater ability today to capture margins outside of the "feedback loop" of end-product pricing formulas. This also means a substantial volume, well over 85% of product value, is not price-captured nor reflected back to farmers in their milk checks – meaning processors are not really so 'trapped.'

2) Voluntary cost of processing surveys had 50 to 55% of Class III price-reporting plants participating. This means the majority of the proposed make allowance increase for cheese and dry whey is based on only half the picture within a smaller and declining 'price capture' of sales.

3) Without mandatory, audited surveys, the risk of setting make allowances too high is present, as many other unsurveyed products are made in the same plants as the four base commodities are made, as acknowledged by Dr. Stephenson who found it more difficult today than 15 years ago to isolate costs relating to the price-surveyed products.

4) Dairy farmers are at risk, as shown in the 2022 Census of Ag, the growing list of herd dispersals, the tight supply of dairy replacement cattle as farmers seek beef income streams in their breeding decisions. There is a marked contrast between the processing and production sectors in terms of having the wherewithal to reinvest sufficiently in their businesses for the future.

5) **Of the 24,470 dairy farms reported in the 2022 Census, 89% fit USDA's definition of small businesses**. As these family businesses come under price pressure, farm exits have increased, dairy infrastructure and the economic vitality of rural communities are impacted. Pricing formulas that promote more rapid industry consolidation are then developed to solve the farther flung milk collection issues, which in turn can further impacts regional food systems, reducing food system resilience and exposing consumers to increased risk of food insecurity.

6) Make allowance updates by USDA in the future should also be tied to improvements in milk check transparency and expanded price discovery for information purposes. Dairy producers should be able to see what milk is made into and what a hundredweight of milk is worth, similar to the way that beef producers see a carcass cutout value reported by USDA (daily or weekly) on the composite value of all cuts. For example, more mozzarella is produced today than cheddar, but bulk mozzarella prices are not reported by USDA for information purposes.

III. Sync timing of the make allowance and milk composition updates. Both proposed changes impact CME contract formulas that underlie risk management. Why implement the negative update immediately while delaying the positive update for 12 months?

American Dairy Coalition respectfully asks USDA to reconsider the proposed timing for implementation of the milk composition updates, which are based on actual milk component levels today, which have not been updated since 2000 Order Reform was first implemented.

At a time when USDA proposes allowing processors to receive increased make allowances from farmers, why wouldn't USDA offset some of this enormous loss in income by implementing the updates that are proposed to increase milk composition standards at the same time? Farmers deserve to be paid more accurately for the composition of their milk, especially in view of the fact that both proposed amendments – make allowance updates and milk composition updates -- impact CME futures contracts and price risk management programs like Dairy Revenue Protection (DRP) and Livestock Gross Margin (LGM).

According to the American Farm Bureau, the proposed delay in implementing the proposed milk composition updates leaves $200 million in annual pool revenue off the table for dairy farmers for one year while implementing right away the make allowance increases that will extract from pools and farmer milk checks what AFBF estimates is $1.25 billion (with a B) annually. Both impact the formulas that are part of the CME contracts underlying milk price risk management. The proposed make allowances would have an immediate impact on the negative side of the formula equation that is 6 times larger than the impact of the milk composition updates on the positive side of formula, which is much smaller, but is being delayed.

On the proposed milk composition update, Sam Schwoeppe, an Indiana dairy producer testified Aug. 25 (hearing transcript pages 600-622) regarding the advancements in milk composition over nearly 25 years since protein, solids-nonfat and other solids component levels were standardized for Class I in 2000:

> *"We have to get better every single day to be able to stay competitive. Everything that we produce on our farms is of value, and we are at the bottom of the food supply chain. We talk about added value products that our processors do for us, and when we talk about the base price, we as farmers need to focus on our retained value. So when we have an inequity like this, it allows -- it allows there to be advantages. We have heard different testimony where one region may have an advantage over another. And what is so powerful about the Federal Order system is that they level that across the country.*
>
> *So let's just say, we're all playing the game of baseball, and some of us have the rules of softball, and some of us have the rules of baseball, but we're all playing the same game.· And there's no equity in that."*

Ken Nobis, a Michigan dairy producer, testified Aug. 30 (page 1294 of transcript). He highlighted how dairy farmers

> *"have been working diligently through the years to improve the milk production and component makeup of the milk that they produce. Dairy producers are very innovative. They are willing to adopt new technology to keep the business viable and to meet the expectations of the consumer… But technology is becoming ever more expensive to implement, and producers need an economic signal from the marketplace that provides the necessary incentive to continue to be innovative."*

Processors have innovated – using more milk to make products outside of the product pricing formulas to recover margin downstream in the marketplace instead of relying solely on fixed margins from make allowance credits deducted farm milk prices upstream. Farmers produce just one product – milk. They can improve components that allow more products to be made per hundredweight of milk shipped, but they are still in that one-product loop.

If USDA moves forward with proposed make allowance increases in 2025, then the updated milk composition standards should be implemented at the same time. Both pieces of USDA's Recommended Decision impact risk management, so why stagger them?

Dairy farmers face price risk heading into 2025. These are uncertain times for markets and policy. There is little to no activity occurring on the CME board for milk futures contracts (or DRP) beyond February 2025, due to traders sitting on the sidelines as they expect USDA may implement make allowance updates that would cause Class III and IV milk prices to drop by 75 cents to $1.00. Farmers once again find themselves with fewer risk management options at a time they may need it most.

Thank you for your consideration of our feedback and requests,

American Dairy Coalition