

BEFORE THE SECRETARY OF AGRICULTURE
AGRICULTURAL MARKETING SERVICE

In the matter of:	)	
	)	
Proposed Amendments to	)	Docket No.
Marketing Agreements and Orders	)	23-J-0067
	)	
(Pricing Formulas)	)	AMS-DA-23-0031
	)	

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Post-Hearing Brief of the American Farm Bureau Federation

The American Farm Bureau Federation (AFBF) hereby submits its post-hearing brief in the above-captioned proceeding. As the nation's largest general farm organization, AFBF represents nearly 6 million member families in all 50 states and Puerto Rico. AFBF policies are developed and approved by farmers. In recent years AFBF's members have taken a leading role in federal milk marketing order (FMMO) policy in order to ensure that farmers are represented directly, in addition to the important representation that many – but not all – receive through the activity of their cooperative associations. To that end, AFBF organized a Dairy Working Group, which spent more than 3 years diving into the details of FMMO's and developing a series of recommendations. In addition, AFBF hosted a Federal Milk Marketing Order Forum in Kansas City in October 2022, attended by 300 dairy industry leaders, the majority of whom were farmers, to develop a set of FMMO policy priorities. These recommendations and priorities were then carried home to county Farm Bureaus, where the formal policy development process led to votes by state and national farmer delegate bodies, and the refined set of policies on which AFBF's proposals for this hearing, as well as our positions on others' proposals, are based.

The proceeding was initiated to consider proposals to amend the four class price formulas applicable to all federal milk marketing orders. AFBF initiated 4 of the 21 proposals heard by USDA, and has positions on several others. This brief will address the general problem of price misalignment and de-pooling, which underlies consideration for AFBF's positions on many of these proposals; it will then incorporate those parts of the hearing record that elucidate our positions on all of the proposals, in order, including AFBF proposals.

Letters submitted to the Secretary during the post-hearing brief period are addressed in substance in the comments on proposals 7, 8, 9, and 13, and with respect to process before the conclusion.

Addressing Price Misalignment and Depooling.

In the months leading up to the announcement, there was discussion as to whether it would consider de-pooling, *per se*, or not. De-pooling and associated large negative producer price differentials have been one of the major frustrations of dairy farmers with FMMO's.

It has been conventional wisdom that negative producer price differentials (PPD's) and their amplifier, de-pooling, must be addressed through rules that would define pooling standards and penalties for de-

pooling. While such rules have their place, in many cases, this is trying to force actions that would be more effectively encouraged with the right incentives.

We believe that many of the fundamental causes of negative PPD's and depooling are contained in the price formulas that are at issue in this hearing, and that it is fortunate we have the opportunity to address those formulas before we attempt to further push the rope of forcing pooling on unwilling handlers. Indeed, rules to discourage depooling will be much more effective if the frequency and magnitude of price misalignments and associated negative PPD's is substantially reduced.

This hearing was initiated to reduce all four class prices through an increase in make allowances. The cornerstone of our positions and our arguments is the need to reduce price misalignments, negative PPD's and de-pooling. To that end, Class I and II prices should be increased in ways that are consistent with FMMO principles, offsetting considerations should be applied to the proposals to reduce Class III and IV prices, and the calculation of all four class prices should be synchronized to provide more consistent price signals. All of these changes will better align class prices, reduce the frequency and size of negative PPD's, and lead to a substantial reduction in de-pooling.

Dairy farmers suffered negative PPDs during 2020 and 2021 with average all-market PPDs reaching over -\$7 per hundredweight, which showed up as a massive deduction on milk checks.

According to the *Journal of Dairy Science* peer-reviewed article entitled [Negative producer price differentials in Federal Milk Marketing Orders: Explanations, implications, and policy options¹](#), among the biggest causes of negative PPD's were 1) the large Class III-Class IV spread, 2) the "average-of" Class I price formula, 3) advanced pricing of Class I milk and 4) the resulting depooling, which amplifies the problem. Many AFBF proposals and AFBF support for other proposals from other stakeholders are focused on reducing the prevalence of PPDs by reducing the frequency of these occurrences and the negative PPD's that contribute to disorderly marketing.

Currently, the classified prices for each month are announced at two different times. The advanced prices are announced by the 23rd day of the preceding month. For example, September's advanced prices are announced on or before August 23. Advanced minimum prices are announced for Class I, Class I skim, Class I butterfat, and Class II skim. By the fifth day of the following month, the Class II, Class II butterfat, Class III, Class III skim, Class III butterfat, Class IV, Class IV skim, and Class IV butterfat prices are announced. These prices for September are announced on or before October 5. This arrangement creates a long lag between when the advanced prices and current prices are announced for that same month and means that the advanced prices (Class II skim milk and components and Class I skim milk and butterfat) can be based on weekly data that is 25 to 40 days older, on average, than the basis for the "current" prices (Class II butterfat and all Class III and IV prices).

This means when market prices rise rapidly, announced (final) prices can be much higher than advanced prices, leading to a misalignment between class prices in which the Class I mover can be well below the Class III or IV prices. This leads to low and negative PPDs. This creates an incentive for both cooperative and proprietary handlers to de-pool milk from the order to capture the high Class III or IV milk value

¹ Marin Bozic, Christopher A. Wolf, Negative producer price differentials in Federal Milk Marketing Orders: Explanations, implications, and policy options, *Journal of Dairy Science*, Volume 105, Issue 1, 2022, Pages 424-440, ISSN 0022-0302, <https://doi.org/10.3168/jds.2021-20664>.

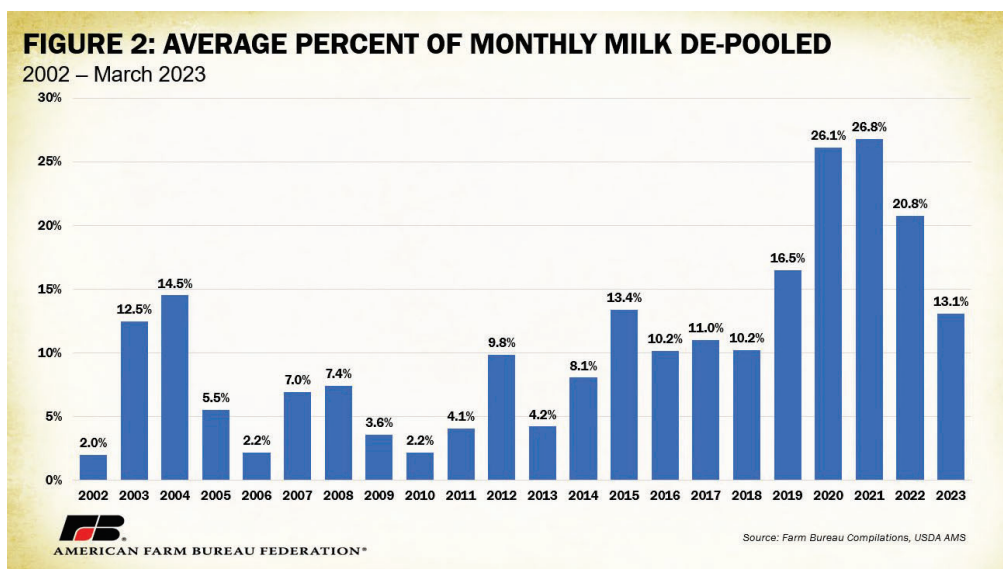
without sharing that value with the pool. This further depresses the PPD, and undermines the FMMO principle of uniform pricing.

This is why correcting class price misalignments is the appropriate first step in addressing negative PPD's and depooling.

USDA acknowledging the impact of these conditions at the time of order reform:

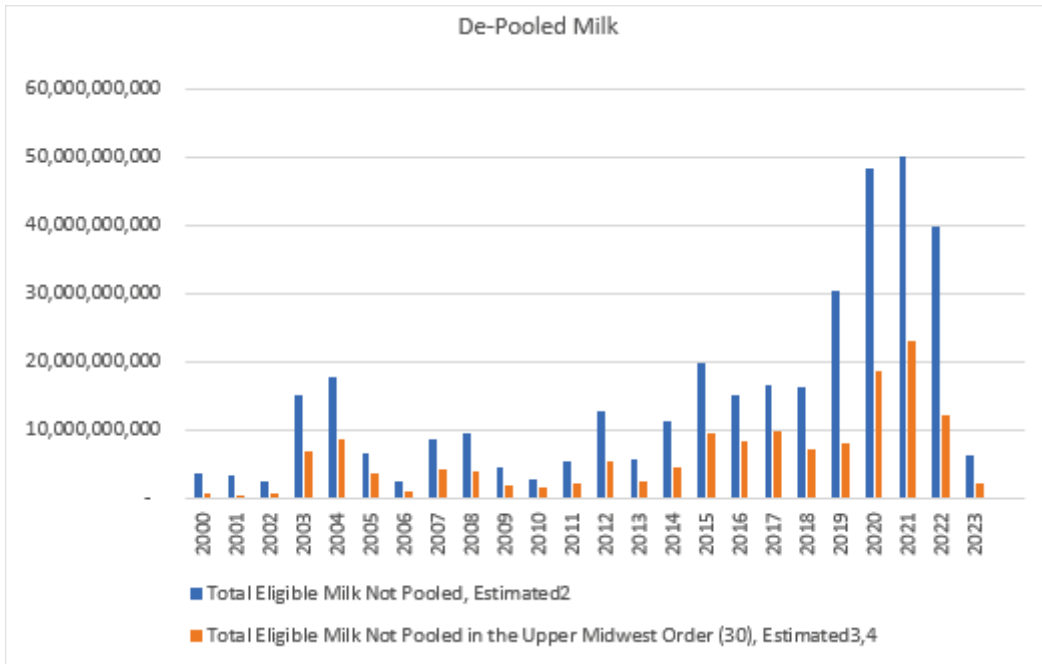
"Milk used in Class I in Federal order markets must be pooled, but milk for manufacturing is pooled voluntarily and will not be pooled if the returns from manufacturing exceed the blend price of the market wide pool. Thus, an inequitable situation has developed where milk for manufacturing is pooled only when associating it with a market wide pool increase in returns. Illustrative of the worsening class price inversion problem are the growing volumes of milk that, while normally associated with Federal milk orders, are not being pooled due to price inversion problems." (64 FR 16102)

Over the past 20 years the percentage of de-pooled milk has increased. Based on data from USDA Exhibit 30, between 2007 and 2012 the average monthly percent of eligible milk that was de-pooled across all orders was 5.7%; between 2013 and 2018 this percentage increased to 9.5%. Between 2018 and 2023, this figure nearly doubled to an average of 18.9% of eligible milk being de-pooled each month. Handlers are de-pooling milk at higher volumes more frequently.



The increase in de-pooling has been correlated with the volatility in class prices at varying levels with a higher positive correlation between wider Class I and Class III ranges and higher rates of de-pooling. More frequent de-pooling has also been positively correlated with lower and negative producer price differentials.

Causes of increased de-pooling: One witness's testimony suggested that the reason de-pooling is up in the FMMO system is because of the addition of the California market. However, de-pooling data for FO 30 shows the same pattern as that in the FMMO system overall; California is not causing the increase in de-pooling. Rising de-pooling is the result of declining Class I use and the falling relative value of Class I differential relative to the underlying milk prices.



Data: USDA/AMS.

The inequitable situation that USDA described over 20 years ago has become increasingly present in today's dairy markets. Eligible processors pool milk when market-wide pool returns are expected to be positive compared to current manufactured class prices but are likely to de-pool milk otherwise. This causes serious competitive inequities among dairy farmers, contrary to the federal order principle of uniform prices. Note also that several orders have implemented provisions intended to discourage de-pooling since order reform, so the full magnitude of class price changes on de-pooling is greater than it would appear from the historical data.

Many farmer witnesses testified to the damage to producers from the chaotic marketing conditions created by negative PPD's, de-pooling, and the lack of uniformity of pay among producers, including the Wisconsin farmer who recounted the variation among farmers' milk checks and how it "pits farmer against farmer. It pits neighbor against neighbor." (Hearing Transcript, p. 1577.

AFBF analysis using price and pooling data from April 2012 through April 2023 found that the Proposal 13 – the return to the "higher-of" – would substantially reduce the number of times that the Class III price would have exceeded the base zone uniform price (that is, negative PPD's), across all orders, from 104 times under the current Class I price formula to 88 times; and it would reduce the number of times that the Class IV price exceeded the uniform price in an order from 53 to 46. The same analysis shows that Proposal 18 – the elimination of advanced pricing combined with the higher-of – would reduce the frequency of negative PPD's by over 40%, from 104 to 61, and the frequency of the Class IV price exceeding the uniform price by 28%, from 53 to 38. This was before considering the amplifying effect of negative PPD's, so that these reductions would probably be greater in the real world. (Exhibit 294)

We also encourage USDA to examine the graphical evidence, in the same exhibit, of the great extent to which various proposals, including Proposals 13, 18 and 21, lead to greater class price alignment. (Exhibit 294. Note that Proposal 17 is a combination of Proposals 13 and 18.)

AFBF believes that disorderly marketing conditions are present when producers do not receive uniform prices because of frequent de-pooling, and that realignment of class prices is the first step to encouraging consistent pooling and uniform pricing.

Category 1. Milk Composition

Proposal 1: Submitted by the National Milk Producers Federation

USDA summary: *This proposal seeks to amend the milk component factors in the Class III and Class IV skim milk price formulas. Specifically, the proposal seeks to increase the skim component factors to equal the weighted average nonfat solids, true protein, and other solids factors for milk pooled on Federal orders using data for the three years prior to implementation, with a 12-month implementation lag. The factors are proposed to be updated as follows:*

- *Nonfat solids: from 9.0 to 9.41 per hundredweight of Class IV skim milk;*
- *Protein: from 3.1 to 3.39 per hundredweight of Class III skim milk; and*
- *Other solids: from 5.9 to 6.02 per hundredweight of Class III skim milk.*

The proponent also proposes the skim component factors be updated no less than every three years, but only once the weighted average nonfat solids component for the prior three years changes by at least 0.07 percentage points. The updated component values would be calculated, and, if a change is warranted, formally announced in February of such year, with the implementation of such changes occurring March 1 of the following year.

AFBF supports the updating of the component values in the Class III and IV skim price formulas, based on the same logic presented by NMPF. Adjusting these values will more accurately define the market value of skim milk used in the skim/butterfat markets and in Class I in all markets, and create a fairer and more logical connection between the manufacturing milk prices and the Class I price, and support the price alignment and reduction in negative PPD's and de-pooling discussed in the first section of this brief.

In component markets, it will ensure that Class I milk prices reflect at least the national average component value, rather than a low outdated value which undermines the premium for Class I milk intended by FMMO pricing formulas, per years of FMMO hearing proceedings. This higher value for Class I will, like the adjustments to the Class I differentials, increase the Class I price (by an average of about \$0.70 per hundredweight, based on a simple average of 2022 data), reduce the incidence of price misalignments with Class III and IV prices, reduce the size and frequency of negative PPDs, and so reduce incentives for de-pooling, which undermines orderly marketing and the principle of uniform pricing in the market.

In addition, raising the value of skim milk in the manufacturing classes (II, III and IV) in the skim/butterfat markets will reduce the current misalignment of FMMO minimum prices for those classes between those markets and bordering component markets. Today, proprietary and cooperative manufacturing plants located in FO 32 or 126, for example, have undue incentive to pool the Class II, Class III or Class IV milk that they receive on FO 5 or 7, for example, because the FMMO minimum price at an average test

for that milk in a skim/butterfat order is substantially lower than the minimum price for the same milk in a component order, based on the current outdated component tests embedded in the current formulas. By USDA's calculations, the simple average of this gap was \$0.52 for Class II, \$0.77 for Class III, and \$0.50 for Class IV, in 2022. The incentive produced by this gap creates undue "pool-riding" in the deficit markets of the Southeast (beyond the incentive of higher uniform prices in those markets). This undermines the uniform price in those markets, which makes supplying those deficit markets more difficult. This unnecessary and distortionary incentive to pool on the 'wrong' market would be substantially reduced by adoption of updated component tests in the skim milk price formulas.

Adjusting these component values in the Class II, Class III, and Class IV price formulas, therefore, will improve the orderly marketing of milk in multiple ways.

Regarding regular adjustments: NMPF also proposes that USDA make periodic adjustments to these component tests to account for what have been continuing increases in the protein test of producer milk. This is based on the component tests "in all orders," according to the proposed regulatory text; this would, presumably, require collection of protein and other solids tests in all markets, including skim and butterfat markets. AFBF has reservations about the potential for downward adjustments to component prices, especially given that downward adjustments could increase the potential for class price misalignments and de-pooling, so recommends that these regular adjustments only be made if they reflect an increase in component tests.

Proposal 2: Submitted by National All-Jersey, Inc.

USDA Summary: *This proposal seeks to amend the milk component factors in the Class III and Class IV skim milk price formulas. The proposal seeks to update the factors annually using the previous year's weighted average calculations, with a 12-month implementation lag.*

Proposal 2 by National All-Jersey is similar in concept to Proposal 1, which AFBF supports.

The annual adjustments would seem to be more disruptive than the tri-annual adjustments proposed by NMPF; however, they are likely to be less dramatic changes each time they occur, and so might smooth the adjustments. AFBF has similar concerns about downward adjustments in the annual update as in the triannual update, and would argue for a formula that only reflects increases in component tests.

Category 2. Surveyed Commodity Products

Proposal 3: Submitted by the National Milk Producers Federation

USDA Summary: *This proposal seeks to eliminate the Cheddar cheese 500-pound barrel price series from protein price formula.*

The American Farm Bureau Federation supports this proposal as written.

As NMPF outlines in its proposal, barrel cheese represents roughly 50% of the volume in the National Dairy Product Sales Report (NDPSR) but is used to set prices for only about 10% of cheese in the U.S. market. Price divergence between block and barrel prices now creates a "cheddar" cheese price for use

in the formulas that is not representative of the value of 90% of cheese. We expect that the elimination of the barrel price from the survey will contribute to an even greater reliance on block prices in the U.S. cheese market, further reinforcing the block price as the appropriate foundation for the Class III protein and skim milk price.

Barrels and blocks are not the same product. Witnesses testified that one cannot turn block cheese into barrel cheese or barrel cheese into block cheese, and that there are significant costs and production barriers to using block cheese for processed cheese production. Blocks cannot be produced in barrel cheese making equipment and barrel cheese cannot be produced using block cheese equipment. That is, blocks and barrels are neither close use substitutes, nor are they close production substitutes, based on entire separation of production processes and equipment. (See Hearing Transcript, 1738 et seq.)

Witnesses indicated that cheese plant operators strive to run their plants full, because they have a substantial capital investment, and keeping capacity slack is expensive. Witnesses also said that, at the time of order reform, cheese plants were more likely to have slack capacity, which allowed more easily for production substitution. That is, milk could be shifted from block production to barrel production, and back, because there was extra processing capacity for both, so prices were likely to track based on the cost of milk. In recent years we have seen cheese plants run full and understood that can lead to substantial divergence of values between blocks and barrels in the short term. The NDPSR is intended to reflect the short-term value of cheese to value cheese milk, but barrel prices – which are about 50% of the survey weight – are really only used to price the 10% of cheese that is made in barrels. (Hearing Transcript, pp. 1858 et seq.)

Barrels should be dropped from the survey whether or not 640-pound blocks are added, per proposal 4.

Proposal 4: Submitted by the American Farm Bureau Federation

USDA Summary: *This proposal seeks to add 640-pound Cheddar cheese blocks to the protein price formula.*

This is consistent with dropping barrels from the survey, per Proposal 3 by the NMPF but, as noted above, does not depend upon that measure.

As NMPF has indicated in that proposal, barrel cheese represents roughly 50% of the volume in the NDPSR but is used to set prices for only about 10% of cheese in the U.S. market. Price divergence between block and barrel prices now creates a “cheddar” cheese price for use in the formulas that is not representative of the value of 90% of cheese.

Numerous witnesses indicated that 640-pound blocks are priced identically, or nearly identically, to 40-pound blocks, and are a standardized commodity cheddar cheese product. So adding 640-pound blocks to the survey would expand the cheddar volume, making the survey more robust generally. No price adjustment is necessary to integrate these larger blocks into the survey, as numerous witnesses indicate – again – that the two sizes are fundamentally interchangeable in price, use, and storage. Both are defined under the same standard of identity (21 CFR 133.113) and both are graded under the same standard. (Barrel cheese is not technically defined as cheddar cheese, does not fall under the same standard of identity and is graded according to a different standard.)

It also means that if barrels remain in the survey, adding 640-pound blocks to the survey would move the balance of blocks and barrels closer (but not close) to the actual market mix.

The record also shows a shift in production and marketing from 40-pound blocks to 640-pound blocks, so that adding 640-pound blocks to the survey now would address the potential for the volume of 40-pound blocks becoming too small to properly validate cheddar cheese market prices in the future. Given the costs and challenges of the FMMO hearing process, it would be better to avoid a future hearing for what seems to be a foreseeable housekeeping necessity.

We expect that the addition of 640-pound blocks to the survey will strengthen price discovery, avoid the potential for block manufacturers to switch between sizes to avoid and re-enter the price survey, and avoid a possible crisis of dwindling small blocks in the future. That is, a large and reliable survey volume will help avoid some sources of disorderly marketing.

NMPF argues that a single product should define the cheese price in the NDPSR, and that this would violate that principle. The record makes clear that 40-pound and 640-pound blocks are a single product, simply in different-sized packaging. Note, in particular, that 40-pound blocks can be stacked to form a 640-pound block and that 640-pound blocks can be cut into 40-pound blocks. This is the same product.

A deeper survey will provide a stronger foundation for the Class III protein and skim milk prices.

Proposal 5: Submitted by the American Farm Bureau Federation

USDA Summary: *This proposal seeks to add unsalted butter to the butterfat and protein price formulas.*

The growing volume of unsalted butter production and use in the U.S. market means that salted-only butter price collection in the National Dairy Products Sales Report (NDPSR) survey increasingly underrepresents the value of U.S. butter.

At the time that the butter price survey was developed by the National Agricultural Statistics Service (NASS) in 1999, it was done in support of federal milk marketing order reform, per the preamble to the recommended decision for order reform, but there was no rulemaking – by AMS or NASS – to establish the logic for excluding unsalted butter. Later regulations in 2008 and 2012 did not address this decision, either. (See 64 FR 16093, 73 FR 34181 et seq., 77 FR 8721 et seq.)

The NDPSR collects prices only for salted, 80% fat butter in 25-kilo and 68-lb. boxes. This only captures a small and declining share of U.S. butter production. Based on a comparison of the NDPSR totals for a 52-week year and NASS dairy products annual reporting, butter in the NDPSR survey has fallen from 16.0% of total butter production (in the original NASS survey) to 10.9% in 2013 and 9.4% in 2022, in the current AMS survey. We have every reason to believe that this trend will continue without the addition of unsalted butter. The rest of the world produces and consumes primarily unsalted butter and growing volumes of commodity unsalted butter are being used by American bakers and confectioners. Although unsalted butter was produced in small quantities in the U.S. at the time of federal order reform, its share of U.S. production and sales has grown very substantially since then and is projected to continue growing. The result of this growth is that a substantial volume of commodity butter is not included in a NDPSR survey and is increasingly underrepresented.

While producing and distributing unsalted butter was once more difficult and expensive for butter plants, and butter was typically salted to allow for extended storage, U.S. butter makers are increasingly offering unsalted butter to domestic and overseas customers, matching the European convention. As a result, the definition of butter in the current data collection is outdated.

The continued specification of salted butter only in the CMEGroup butter market specification is based on old technology; it may still be a reasonable standard in order to assure a uniform product for the cash spot market, but it is unnecessarily restrictive for the purposes of the NDPSR survey, just as the CMEGroup spot exchange specifications for cheddar cheese calls for 40-lb. blocks, but it used to price 640-lb. blocks, as well.

USDA butter grading data demonstrates growth in the demand and production of unsalted butter. Unsalted butter has grown from 13% of graded volume to 30%; this is 355 million pounds, much of which could contribute to price discovery in the NDPSR. (Hearing Transcript, p. 1926) In addition, US butter exports have grown from about 2,000 metric tons in 2000 to over 65,000 metric tons in 2022, almost entirely supplied with unsalted butter. (Find at <https://apps.fas.usda.gov/gats/default.aspx>)

Salted and unsalted butter are graded to the same standard; they are the same product, except for the salt content. (See https://www.ams.usda.gov/sites/default/files/media/Butter_Standard%5B1%5D.pdf) This means that unsalted butter in the NDPSR can and should conform to all the same specifications as salted butter, other than salt content.

Incorporating the unsalted butter price into the FMMO butterfat formula will expand the base of the survey and make the survey price more representative of an evolving butter market. Collecting and publishing separate prices for salted and unsalted butter will allow for better market transparency and more orderly marketing of butter and milk. Witness testimony suggests that unsalted butter is slightly more expensive than salted butter, but we believe that this is a specialty premium that is disappearing as unsalted butter becomes more common. In addition, witness testimony indicates that, while salted and unsalted butter are not near-perfect use substitutes (as 40-pound and 640-pound cheddar cheese blocks are), they are near-perfect production substitutes, since the same butter line can easily shift from salted to unsalted butter and back, so that their prices converge and their role in the dairy market is closely integrated.

Proposal 6: Submitted by the California Dairy Campaign

USDA Summary: *This proposal seeks to add mozzarella to the protein price formula.*

This proposal is consistent in principle with AFBF policy to make the NDPSR more broadly representative of milk use. California Dairy Campaign's proposal, however, did not make clear how this would be implemented.

Category 3: Class III and Class IV Formula Factors

Proposal 7: Submitted by the National Milk Producers Federation

USDA Summary: *This proposal seeks to amend the manufacturing cost (make) allowances found in the four component price formulas. The proposal includes the following increases:*

Butterfat: from \$0.1715 to \$0.2100 per pound of butter,

Nonfat solids: from \$0.1678 to \$0.2100 per pound of nonfat dry milk (NFDM),

Protein: from \$0.2003 to \$0.2400 per pound of Cheddar cheese,

Other solids: from \$0.1991 to \$0.2300 per pound of dry whey.

The requested changes are equivalent to an increase of \$0.0385 per pound in the butter make allowance, an increase of \$0.0422 per pound in the nonfat dry milk make allowance, an increase of \$0.0397 per pound in the Cheddar cheese make allowance, and an increase of \$0.0309 per pound in the dry whey make allowance.

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, were commissioned by USDA with the clear intention of making their results available for proposals to update the make allowance. This, unfortunately, creates an equally clear incentive for dairy manufacturers to be selective in their choice whether 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 at the time of order reform for the development of the make allowances in the price formulas has been substantially undermined by potential bias in the survey. The recent 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.

The last mandatory audited surveys of U.S. dairy processing costs were those of all manufacturing plants in California, 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, the largest butter-producing state since about the same time, with roughly one 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. The California survey represented (and represents) a large and representative sample of commodity dairy processors in its own right, and also provided an important check on the overall results from the voluntary survey. This CDFA survey could provide useful data for a make allowance adjustment, but it was discontinued in 2017, after the promulgation of an FMMO in California.

Our conclusion (and the position of AFBF and the consensus of the breakout groups at the farmer-led Federal Milk Marketing Order Forum held in Kansas City in October 2022) is that any fair update of the make allowances must be based on a mandatory and audited survey of costs and yields at the plants participating in the NDPSR, at a minimum. Although AFBF believes that USDA has the authority to conduct such a survey, based on the authority to collect information needed to show that the order is effecting its intent. (7 USC 608d(1)) In addition, AFBF is working with NMPF and IDFA to pursue federal legislation that would clarify and expand that authority and direct USDA to conduct such a survey.

Also 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.” Although the prices of processing inputs have clearly gone up, so has the efficiency of the bulk of processing. These new plants are redefining the yields and the costs associated with making butter, cheese, nonfat dry milk, and dry whey; and it is not certain that the cost of turning milk into dairy products has gone up at all, unless and until a comprehensive survey can be conducted.

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 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.

Proposal 8: Submitted by the Wisconsin Cheese Makers Association

Proposal 9: Submitted by the International Dairy Foods Association

USDA Summary: *This proposal seeks to update the current make allowances with a 4-year phase-in implementation schedule.*

Proposed Make Allowance Levels (Proposals 8 & 9)

Product	Current	Year 1	Year 2	Year 3	Year 4
Cheese	0.2003	0.2422	0.2561	0.2701	0.2840
Whey	0.1991	0.2582	0.2778	0.2976	0.3172
NFDM	0.1678	0.2198	0.2370	0.2544	0.2716
Butter	0.1715	0.2251	0.2428	0.2607	0.2785

This proposal also proposes not to adopt any of the increases described above if, prior to January 1 of that year, USDA has been provided authority and funding to conduct audited dairy product cost studies of all manufacturers of products used to set Class III and Class IV prices, has promulgated regulations implementing that authority, and has adopted make allowances pursuant thereto.

AFBF Response: AFBF offers a single set of comments and arguments regarding Proposals 8 and 9, as they are identical.

AFBF opposes Proposal 8/9, based on the principles outlined with respect to Proposal 7. AFBF also believes that the ultimate make allowance increases sought in this proposal are clearly excessive. While NMPF, in Proposal 7, appears to be making an effort to set make allowances at levels that they believe will be borne out by a true accounting of processing costs, WCMA and IDFA appear to be stretching the possible range of credible proposals.

Proposals 8 and 9 use processing input prices to update mandatory audited survey data from California in 2014-2016. AFBF opposes using indexing to adjust make allowances. Over time, input price increases tend to be at least partly offset by productivity increases. (See comments on Proposal 10, below.) 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. (In the economy as a whole, productivity growth must match wage growth, or wages become economically unsustainable.) This is why full plant cost and yield accounting is critical to any fair adjustment of the make allowances.

It is worth pointing to all our arguments against Proposal 7, but particularly to the fact that dairy manufacturing plants continue to be built at a striking pace, which seems inconsistent with the claimed inadequacy of the current make allowances.

AFBF urges USDA to deny these excessive make allowance proposals as they would create a dangerous market imbalance between handlers and farmers.

Proposal 10: Submitted by Select Milk Producers, Inc.

USDA Summary: *This proposal seeks to increase the butterfat recovery factor in the Class III price formula to 93 percent, which would necessitate a corresponding increase in the butterfat yield in cheese to 1.624.*

Consistent with the principles on which AFBF supports Proposal 1, we support the general principle behind Proposal 10. If USDA determines that increased efficiencies in processing have led to higher yields and lower processing costs, those should be reflected in the minimum price, although we recognize the importance of establishing such changes on firm data. It may be reasonable to simply incorporate this into the data collection that we believe is necessary to update make allowances.

The evidence supporting this proposal provides another example of the growing efficiencies that tend to offset increases in the prices of inputs to dairy processing, and which make a fuller (mandatory and audited) accounting of plant costs necessary to make a fair adjustment to make allowances overall.

Proposal 11: Submitted by Select Milk Producers, Inc.

USDA Summary: *This proposal seeks to update the specified yield factors to reflect actual farm-to-plant shrink. The yield factors for nonfat solids and other solids would remain unchanged. The proposed yield factors are:*

Butterfat: 1.22;

Protein value in cheese: 1.386; and

Butterfat value in cheese: 1.582.

Consistent with the principles on which AFBF supports Proposal 1, we support the general principle behind Proposal 11. If USDA determines that increased efficiencies in hauling have led to higher yields from farm milk, those should be reflected in the minimum price. We also recognize the importance of establishing such changes on firm data; but the data upon which this proposal is based appears to be as strong as that on which the original farm-to-plant loss assumption was based. This issue probably does not warrant a formal data collection as extensive as we believe are needed for fair adjustments to the make allowance over time. It is, rather, a one-time recognition that farm-to-plant shrink is much less significant than it once was, or was once assumed to be.

Proposal 12: Submitted by Select Milk Producers, Inc.

USDA Summary: *This proposal seeks to update the nonfat solids factor from 0.99 to 1.03.*

This proposal is straightforward, based on the market's long-term shift to valuing buttermilk near the nonfat dry milk price. Raising the factor to capture this value is consistent with the accounting which USDA has applied to the Class IV formula generally, without necessarily complicating it with a collection of buttermilk prices. Data is not a problem for this proposal, since there is a clear record of buttermilk values since order reform. The record (and AFBF policy) support this change.

Category 4. Base Class I Skim Milk Price**Proposal 13: Submitted by the National Milk Producers Federation**

USDA Summary: *This proposal seeks to amend the base Class I skim milk price in all Federal orders. Specifically, the proposal seeks to replace the simple average of the Class III and Class IV Advanced Skim Milk pricing factors with the "higher of" the two factors and remove the additional \$0.74 per hundredweight.*

AFBF supports NMPF's proposal to return Class I base pricing to the "higher-of" the Class III and Class IV pricing formulas.

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, de-pooling, 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 that processor representatives have insisted make the continuation of the “average-of” formula necessary. The witness for the CMEGroup indicated the exchange’s openness to doing whatever is needed by its customers. (Hearing transcript, p. 803.)

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’.

Finally, a return to the ‘higher-of’ will tend to make Class I prices higher, which support Class price alignment. More particularly, the ‘higher-of’ formula together with the elimination of advanced price, as proposed by AFBF, would entirely eliminate the possibility of Class I prices being lower than either of the Class III or Class IV prices. This elimination of class price alignment would reduce the frequency and magnitude of negative producer price differentials and producer milk de-pooling, which is outlined in detail in the first section of this brief.

Proposal 14: Submitted by the International Dairy Foods Association

USDA Summary: *This proposal seeks to amend the base Class I skim milk price to equal the simple average of the Advanced Class III and Class IV prices, plus the “higher of” either \$0.74 or an adjuster equal to the 24-month (August–July) rolling simple average difference between the Advanced Class III and Class IV skim milk prices.*

Proposal 15: Submitted by the Milk Innovation Group

USDA Summary: *This proposal seeks to retain the current “average of” formula for the base Class I skim milk price and proposes to update the adjuster monthly using a 24-month look back period with a 12-month lag, i.e., the preceding the 13-to-36-month period. The “rolling” adjuster calculation would be the difference between the “higher of” the advanced Class III or IV skim milk price for each month and the “average of” the advanced Class III or IV skim milk price, averaged over the preceding 13-to-36-month period, plus the “average of” the Class III and IV advanced skim milk prices for that month.*

Proposals 14 and 15 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. (See https://en.wikipedia.org/wiki/Rube_Goldberg.)

There has been a suggestion that eliminating advanced “higher-of” Class I pricing creates an unbearable loss of risk management opportunities if the CMEGroup does not implement a Class I futures/options complex. Again, we believe, based on the testimony of the CMEGroup witness, that Class I futures and options (or 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. This would be the simplest and most obvious solution to milk handlers’ concerns. However, if the CMEGroup declined to offer this product, there are other exchanges that could clear dairy contracts, including ICE and the Minneapolis Grain Exchange, or companies that could facilitate swaps, such as ever.ag (formerly dairy.com). (Hearing Transcript, page 803.)

Regarding the difficulty of Class I and Class II handlers in managing price risk: dairy farmers (and many other farmers) despite operating on a significantly smaller scale than even a “small” dairy processing business (which has up to 1,150 employees, according to the Small Business Administration), manage myriad price risks – for their feed purchases, their energy costs, their milk sales, their crop sales, etc., through the use of an interlocking collection of government risk management programs, contract pricing, swaps, and hedging on futures and options exchanges. If the CMEGroup (or any other exchange) were to establish the long-overdue set of Class I milk futures and options contracts, such risk management for processing operations that are several times as large as a “large” dairy farm are not an unreasonable expectation of doing business. The price risk faced by Class I handlers is much simpler than what many farmers face, and the existence of Class I futures and options would make it simple to solve.

Proposal 16: Submitted by Edge Dairy Farmer Cooperative

***USDA Summary:** This proposal seeks to change the base Class I skim milk price to the announced Class III skim milk price, plus an adjuster. The proposal seeks to amend calculation of Class I prices to use announced rather than advanced prices. The proposed adjuster would be a 36-month average (August–July) of the monthly differences between the “higher of” the advanced Class III skim milk price or advanced Class IV skim milk price, and the Class III skim milk price.*

AFBF opposes the Edge proposal to use the Class III price plus an adjuster as the Class I price mover.

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 hearing 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 over-complicated design that delays payment to farmers and undermines the proper alignment of Class prices, to which their proposed elimination of advanced Class I pricing might otherwise support.

We believe, as the Edge’s witness, 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: Submitted by Edge Dairy Farmer Cooperative

***USDA Summary:** This proposal seeks to use the “higher of” the Class III skim milk price or the Class IV skim milk price to calculate the base Class I skim milk price. The proposal also seeks to amend calculation of Class I prices to use announced rather than advanced prices.*

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

Proposal 18: Submitted by the American Farm Bureau Federation

***USDA Summary:** This proposal seeks to eliminate the advanced pricing of Class I milk and components, and Class II skim milk and components. As proposed, the Class II skim milk price would be equal to the Announced Class IV skim milk price plus the Class II differential; the Class II nonfat solids price would be equal to the Announced Class IV nonfat solids price plus one-hundredth of the Class II differential. The proponent proposes the Class I skim milk price would be the “higher of” the Announced Class III or Class IV skim milk prices 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.*

AFBF proposes to end the advanced pricing of Class II skim milk and components and Class I milk and components, in support of Class price alignment, which will reduce the frequency and magnitude of negative producer price differentials and of de-pooling, as detailed in the first section of this brief.

The impact of advanced pricing on the orderly marketing of milk is not new to FMMO discussions. In fact, USDA has acknowledged the impact of lagged fluid and manufacturing Class pricing on orderly marketing of milk. For example, on April 2, 1999, in the final decision for federal order reform, USDA states,

“Since Class I handlers must compete with manufacturing plants for supply of milk, the Class I price must be related to the price of milk used for manufacturing.

It is apparent from the price patterns of a large part of 1998 that the current two-month lag between manufacturing and fluid pricing does not establish as close a relationship between the two price levels as is desirable. Indeed, from an analysis of the differences between prices generated by a six-month declining average and the current pricing system, it is clear that the current two-month lag does not accomplish any closer relationship between manufacturing and fluid prices than would the six-month declining average.

When manufactured dairy product prices are relatively stable the advance pricing of Class I milk works quite well. However, since 1988 the volatility in the manufactured dairy product market has caused problems with the advance pricing of Class I milk. The first problem is readily evident in class price relationships during the latter part of 1998. The frequent occurrence of price inversions during that period indicates that some alteration to both the proposed and current methods of computing and announcing Class I prices may be necessary. Class price inversion occurs when a market's regulated price for milk used in manufacturing exceeds the Class I (fluid) milk price in a given month and causes serious competitive inequities among dairy farmers and regulated handlers. Advanced pricing of Class I milk actually causes this situation when manufactured product prices are increasing rapidly.

Since the Class I price is announced in advance, in a rapidly changing market the Class I price may not reflect the value needed to compete for the necessary raw milk supply or the Class I price may be overvalued relative to the raw milk price. Undervaluing Class I milk is a particular problem since it reduces producers' pay prices at a time when the producers should be receiving a positive price signal.” (64 FR 16102)

The conditions USDA refers to from over 25 years ago, related to price inversions, rapidly changing markets and resulting competitive inequalities among dairy farmers, have continued and been made worse by growing volatility in the dairy market. A look at the graph of the Class III and Class IIIA/IV prices since 1998 shows instantly how much more volatile the underlying prices in the federal order pricing system have become. Dairy farmers have had to deal with wide and rapid spreads in prices that have contributed to income uncertainty and disruptions in their ability to manage risk.

Again, when market prices rise, Class III or IV prices rise above advanced prices, and low and negative PPDs result, handler de-pooling of producer milk further depresses the PPD. In these cases, producers who incur the additional costs of consistently servicing the Class I needs of the market, and who are locked into the pool by their service of that market, often receive a lower return than they could have received from handlers who are free to de-pool. The result is that prices received by dairy farmers in a market will not be equitable or uniform when such Class price misalignments drive de-pooling.

After this thorough discussion in the final decision's preamble, USDA ultimately decided to reduce the time lag between advanced and announced prices by about 18 days with the intention that price inversions and associated de-pooling behavior would be reduced. USDA defended their decision with several important points. Firstly, the NDPSR, which includes statistics and pricing information used in the first step of establishing a minimum pay price are announced publicly every week. Therefore, as USDA put it at the time, “handlers can update formulas on a weekly basis to estimate what the Class I price will be before the price is announced.” (64 FR 16103)

Today, Class IV and related futures contracts exist on the CMEGroup exchange to effectively forward price Class II skim milk and Class I butterfat without advanced pricing. There are not currently

CMEGroup contracts that would effectively forward price Class I skim milk based on the higher of current Class III or Class IV skim milk prices. However, AFBF is supportive of, and expects to be engaged in, the development of a Class I futures and options complex at the CMEGroup, to assist fluid handlers in managing risk. The CMEGroup witness, when asked in the context of regulatory changes if that exchange would consider adding a Class I futures contract, said “We’re always open to engagement with the industry on additional tools to suit the industry’s needs.” (Hearing Transcript page 803) There is every reason to believe that, when called upon by the industry, the CME would develop contracts to meet such risk management needs. Denying good regulatory policy to conform to current CMEGroup contract specifications, when the CMEGroup has indicated a willingness to “suit the industry’s need,” is a case of letting the tail wag the dog, even when the tail has said it could accommodate the dog.

Numerous witness opposing this change admitted that the industry had simply gotten used to Class I advance pricing, and this was their primary reason for opposing its elimination.

AFBF believes the current system of advanced pricing contributes to the frequency and magnitude of de-pooling. It should be eliminated.

Category 5. Class I and Class II Differentials

Proposal 19: Submitted by the National Milk Producers Federation

***USDA Summary:** This proposal seeks to update the Adjusted Class I differentials as referenced in all Federal orders for the 3,108 named counties, parishes, and independent cities in the contiguous 48 United States. The proposed update would increase Class I differentials at all locations, in varying amounts.*

AFBF supports NMPF’s proposal to update Class I differentials to reflect changes since 1998.

AFBF agrees with NMPF that Class I prices need to be updated. Over-order prices are “ephemeral” and regulated Class I prices are more “durable” (Jeff Sims testimony, p.18). In effect, the ebbs and flows of local and regional market conditions, without a meaningful minimum price structure, can rapidly wash away a sound long-term price relationship, which may be hard to re-establish, short of the deterioration of a city’s fluid milk supply.

FMMO’s, from their earliest days, recognized that short-term events and market conditions could lead to the destruction of long-term supply and demand stability. Farm policy is broadly aimed at providing some certainty and stability for farmers in the face of natural extreme volatility.

The current Class I differentials are largely based on a 1998 analysis of supply and demand volumes and plant locations, at that time. Even those differentials updated for Southeastern markets in 2008 were only partially reflective of the conditions at that time, because they had to remain aligned with the rest of the country, where differentials remained unchanged.

NMPF’s proposed increases are quite moderate, perhaps too moderate.

The Class I differential consists of two parts: 1) a minimum element, reflecting the minimum additional Class I value necessary to provide a hundredweight of Grade A milk to the fluid market; and 2) a location-specific value over and above this, reflecting the relative difficulty (at a defined cost) of

attracting an additional hundredweight to a particular location, relative to the location with the lowest such cost.

The current **minimum Class I differential** is \$1.60, based on long-standing economic logic, though using outdated cost assessments. This was not updated at the time of Order Reform in 1999, so is even more out of date than the location-specific element. This is discussed in more detail in our comment on Proposal 20.

The current **location-specific values** are based on that 1998 analysis, and are badly out of date, given general inflation, if nothing else, and shifting milk supply locations.

It is critical to understand that the relative Class I differentials also define the producer price differentials; so that the setting of a Class I differential in any county not only defines the price of Class I milk in that county relative to the rest of the country, but also defines the price of producer milk relative to the rest of the federal order market. In fact, the setting of the Class I differential for each county with a plant receiving pooled milk on an order will affect the minimum producer price for every other county receiving pooled milk.

The new analysis by Dr. Nicholson is done with a more detailed version of the model used in 1998, and is based on 2021 data. This provides a critical update to the current Class I differentials, based on the same principles applied to the development of those differentials. (See exhibits 301, 302.)

Testimony by Stephen Zalar (Exhibit 308) and Joe Brinker (Exhibit 357) both presented clear evidence of rising milk hauling costs. This is the critical cost element of the Nicholson model, and this rising hauling cost, along with the shifting locations of milk production and dairy product demand, provide the critical foundation for the update and increase in the relative Class I differentials.²

The Nicholson model's milk movement results represent an efficiency-maximizing/lowest-cost distribution of milk, which is what an ideal market solution would produce. The actual market will achieve a slightly less efficient result. The model's relative milk value results represent the efficiency-maximizing/lowest-cost relative costs of delivering milk from current milk production areas to consumption areas covering every county in the country. The actual market solution will have a slightly higher spread across the country, which means that the model results are a relatively conservative foundation for the Class I price surface. This is the most reasonable and scientific foundation for establishing relative milk values across the country; NMPF witnesses indicated, and examination of the numbers confirm, that the model results are the foundation of the NMPF proposal. However, it is appropriate to make some adjustments based on real-world circumstances, as NMPF has attempted to do. (E.g., Exhibit 302; Hearing Transcript, pp. 8312 et seq., pp. 8451 et seq., pp. 8367 et seq.)

We also question whether the use of the average of May and October model results was an appropriate starting point, rather than the October results alone, which are effectively the "higher-of" the May and October results, as presented. In some markets, such as the Southeast and, to a lesser extent, the Northeast, producers and processors face the greatest balancing and supply challenges in the summer

² Rising hauling costs are also demonstrated by studies conducted by USDA (*Milk Hauling Charges in the Upper Midwest Marketing Area, May 2022*, Staff Paper 23-01, by Corey Freije, Federal Milk Market Administrator's Office, Minneapolis. See <https://www.fmma30.com/StaffPapers/StaffPaper--23-01.pdf>; https://www.fmma30.com/Staff_Papers.html. Overview of Hauling Charges by Location and Size-Range of Production, Pacific Northwest Order, May 2022. <https://fmmaseattle.com/statistics/HaulingOverview2022.pdf>; <https://fmmaseattle.com/staffpapers.html>) These are identified in AFBF's written testimony, Exhibit 383.

and fall. It is arguable that this should have been the foundation for setting the Class I location differentials.

AFBF proposed the introduction of seasonal Class I differentials. This proposal was rejected, but the greater difficulty of serving some markets in the late summer and fall is well demonstrated by the comparison of May and October results from the analysis by Dr. Stephenson and shared by NMPF. These seasonal challenges, in the absence of seasonal Class I pricing, may be best addressed within the current hearing by using the October results in setting Class I differentials.

Again, we recognize that there should be some adjustments to specific location differentials, based on details that better reflect fairness and efficiency than the abstraction of the model. The model reflects an engineering solution adopted for a centralized management of the whole milk system; it is reasonable foundation for the overall analysis of efficient milk movement, but this is the sort of linear optimization economics done by central planners in the Soviet Union. It does not account for competition among processors across a natural market, such as a metropolitan area. Rather, it solves by allocating milk in a way that fluid milk from only one plant would be delivered to a particular location, and cheese from only one plant would be delivered to that same location.

This sort of variation from initial proposals was necessary in 1999 to establish the current differentials, and they are appropriate in this proceeding. Some participants appear to believe that NMPF and its committee have attempted to stack the deck in their favor. We don't believe that has been demonstrated, but we also believe that AMS Dairy Program has the capacity to fairly evaluate these options based on the record. AFBF trusts that the resulting decision from USDA will be based on the model results and the rest of the hearing record and will define and implement Class I differentials based on fair and appropriate adjustments to those results, including due consideration of the proposed adjustments by NMPF. To that end, AFBF encourages USDA to review the maps showing the variation between the model results and the NMPF proposed differentials as part of its evaluation. (Exhibit 384.)

Proposal 20: Submitted by the Milk Innovation Group

USDA Summary: *This proposal seeks to lower the current base Class I differential from \$1.60 to \$0.00.*

AFBF opposes Proposal 20, which would lower the minimum Class I differential to \$0.00, and urges USDA to consider raising it, based on the same logic that entered into its original calculation at the time of order reform.

The current Class I price differential surface lays on the foundation of the minimum Class I differential of \$1.60. That minimum should be updated up, not down.

The minimum \$1.60 Class I differential was established on sound bases during federal order reform; this is particularly laid out in the proposed rule issued on January 30, 1998. Its underlying logic was sound, though its application was conservative. The proposed rule laid out – very effectively – three cost elements that justified the \$1.60. However, there is also a logic for its overall size, which is that the Class I differential must be large enough to allow for a consistent hierarchy of class prices. Either or both can justify the current \$1.60 minimum or more, but not less. (63 FR 4907-4909)

Proposal 20 opened the scope of the hearing for changing the size of the minimum Class I differential by proposing to reduce it to zero (and not to eliminate it). AFBF proposed on the record that it be increased, based on the same logic upon which it was originally proposed in 1998. There is justification for substantial increases, based on increases in all the costs that entered into the original USDA estimate of \$1.60. Increases in Grade A production costs, increases in marketing and hauling costs, and the greater challenges of getting manufacturers – especially cheese plants – to give up milk for supplemental fluid needs, all argue for a higher minimum Class I differential. etc., consistent with the rulemaking that established the current \$1.60 minimum. (63 FR 4907-4909; Exhibit 383)

This same logic could have supported adding another 60 cents or more to the Wisconsin model results as the starting point, rather than the model results based on a minimum \$1.60 Class I differential.

MIG's proposal to reduce the minimum Class I differential from \$1.60 to \$0.00 seems like a rhetorical exercise, designed to make the status quo, or Class I differentials nearer the status quo, appear like a reasonable compromise relative to NMPF's proposal to update and increase Class I differentials.

USDA found costs associated with 1) meeting the Grade A standard, 2) balancing supplies at bottling plants, and 3) providing a basic incentive to supply bottling plants over and above other plants. Taken on their face, the arguments of MIG to eliminate the minimum \$1.60 Class I differential, established in the 1998 and 1999 federal order reform decisions, are rooted in an offhanded dismissal of the elements of the \$1.60 laid out by USDA at that time; this may amount more accurately to a dismissal of the federal milk marketing order system itself, which has been built on these objectives. Each of these three elements is important to the FMMO system, in addition to the fact that class price alignment depends fundamentally on the maintenance of a substantial minimum Class I differential.

We consider each of these four issues below, the three elements laid out by USDA in 1998 and the overall issue of a sufficient Class I differential to maintain basic price alignment.

Grade A Incentive

The FMMO's have provided, and continue to provide, a sound incentive to producers to maintain Grade A status. Claiming that there is no longer a need for a minimum Class I differential because nearly all milk is Grade A is akin to claiming there is no longer a need for stop signs and traffic signals because there are few accidents at intersections. The minimum Class I differentials should not only be maintained, but increased in line with the increased costs of meeting the Grade A standard, and consistent with NMPF's proposal, based on the logic presented by NMPF and selectively summarized in our discussion of Proposal 19.

In the Proposed Rule for Order Reform, USDA set the minimum Class I differential at \$1.60 per hundredweight, based upon several enumerated costs, beginning with the costs of maintaining Grade A standards.

Per the decision:

There are several requirements for producers to convert to a Grade A dairy farm and then maintain it. A Grade A farm requires an approved water system (typically one of the greatest conversion expenses), specific facility construction and plumbing requirements, certain specifications on the appearance of the facilities, and required equipment and facilities, and adhere to certain management practices.

Often this will require additional labor, resource, and utility expenses. It has been estimated that this value may be worth approximately \$0.40 per hundredweight. (63 FR 4908)

Grade A standards have only become more exacting in the meantime, through a state-federal process of review and revision culminating at the bi-annual National Interstate Milk Shippers conference. (See *Grade A Pasteurized Milk Ordinance, 2019 Revision*, Food and Drug Administration, at <https://www.fda.gov/media/140394/download>. See also *Milk for Manufacturing Processes and its Production and Processing, Recommended Requirements*, Effective July 21, 2011, USDA/AMS/Dairy Programs. <https://www.ams.usda.gov/publications/content/milk-manufacturing-purposes-and-its-production-and-processing>.)

Of course, the "labor, resource, and utility expenses" of dairy farmers, cited above, rise along with those of milk processors. Non-feed costs in the production of milk, which are closely identified with "labor, resource, and utility expenses" plus the cited infrastructure costs, have risen by 68% between 1998 and 2022, according to USDA estimates. Based on the above, and applying the same 68% increase to the 40 cent per cwt. cost of maintaining Grade A supplies, AFBF conservatively estimates the present costs of maintaining Grade A standards at 67 cents per cwt. an increase of 27 cents from the status quo. (See ERS Milk Cost of Production Estimates, at <https://www.ers.usda.gov/data-products/commodity-costs-and-returns/commodity-costs-and-returns/#Historical%20Costs%20and%20Returns:%20Milk> and <https://www.ers.usda.gov/data-products/milk-cost-of-production-estimates/>)

Balancing Incentive

Balancing incentives are a critical element of the minimum Class I differential, because supporting balancing is a critical function of the FMMO's themselves.

USDA's order reform decision also stated:

Traditionally, the additional portion of the Class I differential reflects the marketing costs incurred in supplying the Class I market. These marketing costs include such things as seasonal and daily reserve balancing of milk supplies, transportation to more distant processing plants, shrinkage, administrative costs, and opportunity or "give-up" charges at manufacturing milk plants that service the fluid Class I markets. This value has typically represented approximately \$0.60 per hundredweight. (63 FR 4908)

Most of these are the same costs associated with the operation of plants producing such products as cheese, dry whey, butter, and nonfat dry milk powder.

The operators of cooperative supply plants often sacrifice plant profitability of their manufacturing operations in order to provide Class I and II milk supplies. The costs of this supply rise as energy costs and per-pound processing costs rise, and these costs should be offset in the Class I price. Shipping milk from distant sources imposes an even larger cost of balancing Class I markets: transportation costs also rise with higher energy prices as was acknowledged in the 2006 tentative partial decision on transportation credits in the Southeast and Appalachian markets. The manufacturing costs estimated from recent surveys tend to reflect costs of plants running near capacity; processing costs of balancing plants are higher, and should be reflected in the Class I price. In addition, some part of the costs of plant operation are associated with maintaining certification to supply milk to Grade A fluid milk plants, costs that are required of a plant before it may be pooled in the federal order system. Very conservatively, the same percentage increase in the costs of butter and powder manufacture (the primary" form of market

balancing through manufacturing) that is applied to Class III and IV make allowances should also be applied to the 60¢ supply cost. Increases in the make allowance, or manufacturing cost data, since 1998 should be applied to the 60¢ supply cost. The current total make allowance for Class IV milk is \$2.17 per cwt. of milk at 3.5% butterfat; this is up more than 31% from the per cwt. make allowance at the time of order reform, \$1.65. Applying this increase to the 60¢ handler fluid supply costs would be an increase of 19¢. Similarly, any increase in the Class IV make allowances should be applied to this factor, as well. (63 FR 4909; 71 FR 54118, et seq.)

Manufacturing plants are larger and more dependent on running full for profitability. This means that give-up charges are higher than ever, and that cooperatives and the few other handlers who take on balancing responsibilities are facing ever-higher costs to do so.

In addition, shifts in milk production and manufacturing consolidation have led to longer hauls to Class I plants. Studies by the Minneapolis Market Administrator and its Chicago predecessor concluded that the weighted average hauling charge in the Upper Midwest market in May 1998 was 17.6¢ per cwt. and the weighted average hauling charge in the Chicago Regional market in May 1999 (the first year for which data was compiled for this market) was 11.1¢ per cwt. The first data for the consolidated Upper Midwest market is for May 2001, when the average hauling rate was 17.1¢. By May 2006, the average weighted average for the consolidated Upper Midwest market was 23.5¢, 6½¢ higher than 5 years earlier, and 6¢ and 12¢ higher than the figures for the predecessor markets. In 2022, this average hauling cost had risen to 41.53¢ per cwt, an increase of 143% from 2001, or 24¢ per cwt. Similarly, studies by the Seattle Market Administrator showed average hauling rates rising from 43.39¢ per cwt. in 2000 to 51.7¢ in 2005, then to 95¢ per cwt. in 2022, an increase of 118%, or 52¢ per cwt. Based upon these studies, and the rest of this hearing record, we would conservatively propose an additional 25¢ per cwt. in average Class I assembly costs, to be applied to the minimum Class I differential, for a total increase of 44¢ in the Class I differential associated with the incentive to serve the Class I market.³

Incentive to Serve Class I Customers

The last element of the minimum Class I price, per the proposed rule, was the "additional competitive factor", estimated at 60¢ per hundredweight based upon two price comparisons. The proposed rule reported that Grade A milk received an average premium above Class III in 1995 and 1996 of 86¢ in Minnesota and 89¢ in Wisconsin. By 2022, those premiums were 62¢ and 84¢, respectively. (See Table 1.) This is lower than the numbers on which the original 60¢ was based, but not substantially, and certainly not to zero. These continuing premiums are an indication of the necessity of a minimum Class I differential to draw milk to the pool to meet Class I needs, and that they meet the objectives of the Act. There is no call to reduce this element of the minimum Class I differential. (63 FR 4907 et seq.)

³ (Milk Hauling Charges in the Upper Midwest Marketing Area, May 2022, Staff Paper 23-01, by Corey Freije, Federal Milk Market Administrator's Office, Minneapolis. See <https://www.fmma30.com/StaffPapers/StaffPaper--23-01.pdf>; https://www.fmma30.com/Staff_Papers.html. Overview of Hauling Charges by Location and Size-Range of Production, Pacific Northwest Order, May 2022. See <https://fmmaseattle.com/statistics/HaulingOverview2022.pdf>; <https://fmmaseattle.com/staffpapers.html>. All were noted in Exhibit 383.)

Table 1. Comparison of Prices Paid for Grade A Milk Used in Manufacturing Products in Minnesota and Wisconsin to the Class III Price

Year	Minnesota			Wisconsin		Average
	Class III Price	Grade A Pay Price @ 3.5%	Grade A - Class III Difference	Grade A Pay Price @ 3.5%	Grade A - Class III Difference	Average Difference
2021	17.08	17.76	0.68	17.90	0.82	0.750
2022	21.96	22.58	0.62	22.81	0.85	0.735
Average	19.52	20.17	0.65	20.36	0.83	0.743

Sources: USDA, National Agricultural Statistics Service; **USDA, Agricultural Marketing Service;** AFBF calculations. Updated summary version, as much as possible, of Table 7 on 63 FR 4908-4909.

Altogether, increases in the foundation for these three elements justify, not a reduction of the Class I differential, but an increase of approximately 60¢.

AFBF encourages USDA to consider these rising minimum costs of supplying Class I plants, consistent with the logic applied at the time of federal order reform.

Class Price Alignment and Pooling Incentive

Finally, and perhaps most fundamentally, reducing the minimum Class I differential to zero would effectively destroy the basic proposition that Class I prices should be consistently higher than other Class prices, which is critical to the operation of federal order milk pools.

In connection with a return to higher-of pricing and the elimination of advanced pricing, the Class I differentials are the key to encouraging pooling and ensuring a pool draw for manufacturing plants who are ready to serve the Class I market.

Milk prices and milk production costs are all up substantially since 1998. The Class I and II differentials are a fixed element in milk price formulas that need regular updating. Basing this on the three traditional elements is a reasonable approach; however, if the traditional analysis did not support an increase, an increase would still be appropriate to sustain the critical alignment of Class prices. (See the above-referenced Milk Cost of Production data, which includes all milk prices.)

Conclusion regarding Proposal 20: The minimum \$1.60 (or more) is a critical practical element in FMMO pricing and pooling. The \$1.60 minimum is not only still justified, but should be increased, based on increased costs associated with maintaining Grade A standards, of hauling milk, and of balancing weekly and seasonal supplies.

The argument made by MIG in testimony by Ms. Keefe that too high a Class I differential will lead to “overproduction” is spurious. It is not too high in the current market regime, in which manufactured milk products clear in an open international market, and do not back up into government stocks. The purpose of the Class I differential is to ensure a fluid milk supply and orderly marketing of milk overall; a higher Class I differential will do that. It will not cause “overproduction”, *per se*, which doesn’t really exist as long as processing capacity can keep up. (Exhibit 447)

In testimony for MIG, Dr. Stephenson claims that because the average shadow cost for manufacturing milk is higher than the average shadow cost for fluid use, that the minimum Class I differential is not justified. This is a misinterpretation of his own model, which assumes all milk can simply move through

hauling and processing without any significant differentiation among uses. In fact, we have higher prices for Class I because there are many challenges to serving Class I use that isn't captured in the model, including the critical need for steady supplies on daily and seasonal basis, higher quality standards, and the inability to store fluid milk for significant amounts of time. (Exhibit 451)

It is often suggested that fluid milk demand is declining because of the Class I differential. Even in Miami, the Class I differential only represents about 50¢ per gallon. The \$1.60 minimum Class I differential represents less than 14¢ per gallon. And in every part of the country, the Class I differential is a single consistent element of the milk price. If there was a demand impact, it would be a one-time shift in demand, not a long-term decline. Rather, fluid milk demand has been undermined by a shift away from breakfast cereals and the nutrition community's inappropriate and unfortunate encouragement of consumption of unappealing skim and low fat milks, rather than whole milk.

Dr. Kaiser's testimony made clear that there are many reasons for fluid milk's declining demand, and price is not one of them. He also demonstrated that the overwhelming body of economic work on fluid milk demand has shown it to be inelastic, the implication of which is that small increases in the Class I price will have even smaller impacts on fluid milk demanded. (Exhibit 115)

Dr. Capps, stretched to argue that fluid milk demand was elastic. He relied on weekly data, which will include very short-term impacts and store switching which do not accurately reflect overall year-to-year or even month-to-month demand for fluid milk. He used retail data, which reflects the most elastic 76% of overall fluid milk demand, though he acknowledged that the rest of fluid milk demand is relatively inelastic. He also ignored the 0.55 elasticity of price transmission the market from the Class I price to the retail milk price, which further reduces the effective elasticity of fluid milk demand with respect to increases in the Class I price. In fact these numbers suggest that a 1% increase in the Class I price would produce a reduction in fluid milk demand of no more than about ½%. And even this grossly overestimates the impact because of the use of weekly data. (Exhibits 386, 387; Hearing Transcript, pp. 9118 et seq.)

The bottom line is that fluid milk sales will not be greatly affected by any of the changes in the Class I price that were discussed at the hearing.

Ultimately, MIG's proposal to cut the Class I differentials by \$1.60 across the board would overturn Class price alignment, create chaos in FMMO pooling, and effectively destroy the FMMO system.

The destruction of the FMMO system may lead eventually to a stable market structure, but it would be one that could closely resemble that of the current broiler chicken industry, in which integrated processors seize tight control over farmers' prices and operating methods. Similar results have been seen in the United Kingdom and Australia, where large retailers set the milk price, to the long-term detriment of farmers and consumers.

The FMMO system, as it stands today, provides a framework in which farmers can control their own destiny through cooperative organization or through independent reliance on the terms of trade established by the orders and enforced by the market administrator. The FMMO's create a fairer world for dairy farmers in the short run and a market in which farmers are better encouraged to serve American and international consumers in the long run. Dr. Stephenson argues that we are "shackled" to the 1937 Act; rather, the Act provides USDA and the industry enormous flexibility to adjust and

modernize the FMMO's, as we are here to do today. And Congress has stepped in more than once, to call for a full overhaul in 1996, and to, notably, ensure the sufficiency of Class I differentials, in 1985 and 1999.

The system undoubtedly needs updating, as we have argued throughout; however, proposals that would tend to overthrow the entire system, such as Proposal 20, need to be considered not on fine detail, but on the overall impact they would have on the system.

Proposal 21: Submitted by the American Farm Bureau Federation

USDA Summary: *This proposal seeks to update the Class II differential to \$1.56. Specifically, the proposal seeks to calculate the Class II differential using the current nonfat dry milk make allowance multiplied by the current nonfat solids yield factor and updated butterfat and nonfat solids tests for milk in the FMMOs.*

The American Farm Bureau Federation proposes to update the Class II differential based on current drying costs.

The Class II differential was developed during order reform to reflect the cost of drying and rewetting milk, to reflect the higher value of Class II milk without incenting processors to dry and rewet (Class IV) milk for Class II uses. AFBF accepts this logic and proposes to update the Class II differential to \$1.56.

This cost-based element of the Class II price formula is out of date, and no longer meets the purpose of incenting the availability of Class II milk, per USDA's logic at the time of order reform.

Some processors argue that powder is not rewetted for most uses, so that the (minimal) cost of rewetting is not an appropriate consideration for this calculation. For that reason, to be conservative and for simplification, we propose to incorporate only the cost of drying in setting the Class II differential. Ideally, this would be based on a recent mandatory and audited cost and yield survey; in the interim, however, this could be updated using the current make allowance for nonfat dry milk (NDM), together with the current nonfat solids yield factor and updated butterfat and nonfat solids tests for milk in the FMMOs.

The cost of drying skim milk can be calculated as:

$$\text{\$0.1678} \times \text{0.99} \times \text{9.4121} = \text{\$1.56}$$

or

$$\text{NDM make allowance} \times \text{lbs. NDM/lb. NFS} \times \text{avg. lbs. NFS/cwt. skim milk} = \text{cost of drying}$$

The 9.4121 factor is based on the 2022 average nonfat solids test in the FMMOs (9.03%), divided by the average skim milk test (100% - 4.06%). This relies on a butterfat test for all markets and a nonfat solids test for component markets; using the butterfat test for only component markets would raise the differential calculation, since the skim/butterfat markets have the lowest butterfat tests; so, this calculation is conservative.

The original 70-cent Class II differential was nominally based on the cost of drying condensed milk and rewetting it, presumably because dried and reconstituted Class IV milk substituted for Class II skim

condensed milk first, and the differential should not be higher than the cost to convert that relatively standard Class II ingredient form into a Class IV form. Based on the last mandatory audited survey of NDM manufacturing costs, by the California Department of Food and Agriculture, the energy costs of drying skim milk were about 3.5 cents per pound in 2016; given that the energy costs of manufacturing butter were about 1 cent per pound, we will assume that 2.5 cents of the ndm costs are direct energy costs of the drying process. Skim condensed milk contains about 3 times the skim solids as skim milk; so, producing a pound of NDM from skim condensed milk may require roughly a third of the direct energy. This suggests that the cost of producing a pound of NDM from skim condensed milk may be roughly 0.8 cents per pound lower than a make allowance calculated for drying skim milk, which would yield a Class II differential of \$1.49 per hundredweight. (64 FR 16103, et seq.)

However, we believe that the simple update, using the presumed cost of nonfat dry milk processing, achieves the original purpose of the Class II differential without incenting uneconomic drying of Class IV milk for price differences alone. There is no logical reason not to include condensing costs when assessing the cost of using Class IV milk for Class II uses through drying and even the simple addition of powder to a processing vat. Condensing costs would be faced by a Class II processor acquiring milk and using it directly, or condensing it as part of a process of drying it and using it to pay the Class IV price.

Much of Class II use was once part of Class I, based on the idea that it faced similar balancing challenges as Class I. The substantial innovation when Class II was created was to separate it from the location element of the Class I differential. However, there is a reasonable justification for a Class II differential as high as the minimum Class I differential, which is now \$1.60/cwt. and is proposed by NMPF to rise to \$2.20/cwt. In effect, based on the historical logic of the Class II differential, we would argue that the Class II differential should be the lower of the minimum Class I differential and the cost of drying per hundredweight.

The impact of the proposed change to \$1.56 will be to increase the minimum order value of Class II milk by 86¢ per hundredweight, increasing the average pool value in every market and reducing the likelihood of negative PPDs and attendant de-pooling. There were 14.2 billion pounds of Class II milk pooled in 2022; so that in a static analysis, the value of pooled milk would be increased by \$122 million. The \$1.56 differential is lower than the lowest Class I differential (\$1.60), so, combined with a return to the “higher-of” Class I price formula, maintains Class I prices above Class II in every month. (We support Proposal 19, in principle. This proposal would significantly raise Class I differentials, further ensuring that the Class I price should be consistently above the Class II price at any location.)

This change to the Class II differential should be made whether or not advanced pricing is eliminated for Class II skim milk, although the changes are mutually reinforcing, if undertaken together.

Although AFBF opposes any increase in manufacturers’ make allowances under the current conditions, we conclude that if such increases to the nonfat dry milk manufacturing allowance (or adjustments to product yield and milk composition) are made through this proceeding, that a corresponding increase in the Class II differential be made as well. In addition, if automatic updates to the make allowance for nonfat dry milk are implemented through this proceeding, the Class II differential should be updated in lockstep, with language referencing the make allowance and yield, however they may be incorporated into the Class IV milk and nonfat solids formula language. In addition, any one-time or regular updates to the component value of the Class IV milk price formula should be used to adjust the component test factor in the equation above.

Addressing the role and appropriateness of the letters sent to the Secretary during the briefing period

We here address the letters from the American Farm Bureau Federation and National Farmers Union to Secretary Vilsack, regarding 1) the urgency of returning to the higher-of calculation for Class I pricing, and 2) the importance of not increasing manufacturers make allowances in the milk price formulas until the results of a mandatory and audited survey are available.

Both letters were intended as part of the record within the scope of post-hearing briefs. Both were based entirely on the hearing record, and shared with the hearing clerk, the USDA staff managing the docket, and hearing participants generally; they address the Secretary of Agriculture, who is charged with the final decision-making in the current proceeding; and so they are entirely appropriate as post-hearing argument in the federal order hearing process.

- 1) Our joint letter of February 22, 2024, (attached) urged the Secretary to return the Class I base price formula calculation to the higher-of the advanced Class III and Class IV price formulas, and to do it in an expedited manner by omitting a recommended decision, as provided for in 7 CFR 900.12 (d) “if the Secretary finds on the basis of the record that due and timely execution of his functions imperatively and unavoidably requires such omission.” We believe the record supports such a finding, and again urge the Secretary to omit a recommended decision with respect to this issue. We believe such a change should take place as soon as possible. However, if USDA were to agree with other proponents that there should be a delay between announcement and implementation of this change in order to avoid disruption for futures and option users and markets, it remains urgent to begin the process as soon as possible. Omitting the recommended decision with respect to Proposal 13 could also allow for a syncing of immediate implementation of other changes with a delayed implementation of Proposal 13.
- 2) Our joint letter of April 1, 2024, (attached) urges the Secretary not to increase the make allowances for Class III and IV milk components until a mandatory and audited survey of processors costs can be undertaken and the results made available. This is, like the previous letter, appropriately directed to the Secretary as the ultimate deciding official in the current proceeding and – like the previous letter – based upon the hearing record.

Conclusion

The federal milk marketing order system has evolved over the last nine decades. It has provided a stable footing for dairy farmers, dairy cooperatives and dairy processors so that the public could have an ample supply of healthy milk and dairy products. The last 30 years, since the dairy price support program stopped setting the effective price of dairy products, have challenged that system. Federal order reform made necessary adjustments to pricing formulas and applied the higher-of Class III or IV formulas to Class I milk, which worked. They retained advanced pricing of Class II skim milk and Class I milk; this assumed relatively stable month-to-month milk pricing and so failed to maintain stable relationships among Class milk prices as milk prices became more volatile. Since Congress – at the behest of processors and well-meaning cooperatives – mandated the average-of Class III and IV plus 74 cents, the new formula has cost farmers a billion dollars in Class I value.

The FMMO's could not and cannot exist without the support of dairy farmers. Their support has depended on its adapting over time to meet the challenges of an ever-evolving dairy industry.

Today, USDA has the opportunity, based on a strong record, to make critical and overdue updates and adjustments to FMMO milk price formulas that will go a long way to addressing current conditions in the dairy markets, so that the FMMO system can continue to serve the entire industry and the public they serve. Updating component values, increasing Class I and Class II differentials, eliminating advanced pricing, updating products in the formula survey, and – particularly – returning to the “higher-of” Class I price calculation can demonstrate the wisdom and consistency of the Secretary and the Department in addressing the difficulties that dairy farmers have faced in recent years from these outdated elements of the federal milk marketing order price formulas.

Respectfully submitted,

A handwritten signature in black ink, appearing to read 'R. Cryan', written in a cursive style.

Roger Cryan, Chief Economist
American Farm Bureau Federation

CERTIFICATE OF SERVICE

Milk in the Northeast and Other Marketing Areas

Docket No.: 23-J-0067

Having personal knowledge of the foregoing, I declare under penalty of perjury that the information herein is true and correct, and this is to certify that a copy of the POST-HEARING BRIEF OF THE AMERICAN FARM BUREAU FEDERATION has been furnished and was served by electronic mail upon the following parties on April 3, 2024 by the following:

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Docket No.: 23-J-0067

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Docket No.: 23-J-0067

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