



**BEFORE THE UNITED STATES DEPARTMENT  
OF AGRICULTURE  
AGRICULTURAL MARKETING SERVICE**

**In the Matter of Milk in California;  
Notice of Hearing on a Proposal to  
Establish a Federal Milk Marketing  
Order**

**7 CFR Part 1051  
Docket No.: AO-15-0071;  
AMS-DA-14-0095**

**Clovis, California, September 22, 2015**

**Testimony of Paul G. Christ**

**In Support of Proposal 1 of California Dairies, Inc.,  
Dairy Farmers of America, Inc., and Land O'Lakes, Inc.**

**Proposal to Establish a Federal Milk Marketing Order for the  
State of California**

My name is Paul Christ. I have been involved in the Federal milk marketing order program (FMMO) since February, 1961. I have worked for the government in the administration of Federal milk orders, and in the private sector for Land O'Lakes, Inc., where I was responsible for complying with Federal milk order regulations. The range of my experience is outlined in my resume, which is offered as an exhibit.

I appear here in support of the Proposal No. 1, offered by three cooperatives, to adopt a new FMMO for California. This proposal includes some new and unique features that may raise questions among interested parties. My goal is to bring an historical perspective to these questions, to relieve doubts about these features, and to demonstrate that they are appropriate, based on law and/or precedent.

### **Primary Goals of Federal Milk Marketing Orders**

I have read the Agricultural Marketing Agreement Act of 1937 (the Act) several times during my career, including twice during the last few months. Here I paraphrase Section 602 of the Act which states its purposes:

- (1) Establish and maintain parity prices to farmers. Parity prices refer to the purchasing power of farm prices during the 1910-1914 period;
- (2) Protect consumers by gradually approaching parity prices;
- (3) Establish and maintain orderly marketing conditions to promote an orderly flow of product to the Market.

Section 608(c)(18) of the Act is more explicit about milk pricing:

The Secretary of Agriculture, prior to prescribing any term in any Marketing agreement or order, or amendment thereto, relating to milk or its products, if such term is to fix minimum prices to be paid to producers or associations of producers, or prior to modifying the price fixed in any such term, shall ascertain the parity prices of such commodities. The Prices which it is declared to be the policy of Congress to establish in section 602 of this title shall, for the purposes of such agreement, order, or amendment, be adjusted to reflect the price of feeds, the available supplies of

feeds, and other economic conditions which affect market supply and demand for milk or its products in the marketing area to which the contemplated marketing agreement, order, or amendment relates. Whenever the Secretary finds, upon the basis of the evidence adduced at the hearing required by section 608b of this title or this section, as the case may be, that the parity prices of such commodities are not reasonable in view of the price of feeds, and other economic conditions which affect market supply and demand for milk and its products in the marketing area to which the contemplated agreement, order, or amendment relates, he shall fix such prices as he finds will reflect such factors, insure a sufficient quantity of pure and wholesome milk, and be in the public interest.

These themes are recited in the preamble to every Federal milk order decision I have read. My interpretation of the plain language of these sections is that the primary purpose of the Act is to enhance producer prices, with parity price as the goal. Congress also recognized the need to modify prices as market realities dictate, but did not modify its explicit intent to enhance prices to producers.

Proposal No. 1 for the California order does that, without harming consumers, and without disrupting the orderly flow of milk and dairy products to the market.

#### Federal Orders Can Apply to Any and/or All Dairy Products

The Act mentions “milk” seventy-two times. It never specifies “Grade A milk,” so the implication is that an order can be issued for manufacturing milk, Grade A milk, or all milk. Among the references to “milk,” nine refer to “milk and its products,” and six refer to “milk or its products.” Again, the plain reading of the language in the Act leads me to conclude that a FMMO can be adopted to regulate the purchase and handling of any subset of the milk supply, or of any derivatives or products of milk.

There is evidence of this flexibility. Shortly after the implementation of the ~~Agriculture~~ <sup>Agricultural</sup> Adjustment Act of 1933 (a predecessor Act to the Agricultural Marketing Agreement Act of

1937, which included much of the same FMMO language as the 1937 Act), the Secretary of Agriculture issued a “Marketing Agreement” applying to the evaporated milk industry (Baker, Burton A., and Rudolph K. Froker, “The Evaporated Milk Industry under Federal Marketing Agreements”, Research Bulletin 158, University of Wisconsin, September 1945). This regulation operated under three legal constructs, including Marketing Agreement No. 7, Marketing Agreement No. 60, and License No. 100. It regulated manufacturers of evaporated milk across the United States (including those in California), required the payment of minimum prices to (presumably manufacturing grade) milk producers, established minimum and maximum wholesale prices for evaporated milk, and regulated trade practices. The Evaporated Milk License 100, was mandatory, and applied to all processors of evaporated milk in the United States. It was in effect at the time the above referenced bulletin was issued, and continued in effect through 1947.

The Evaporated Milk agreements and license illustrated that both manufacturing grade milk, and a “product of milk” could be regulated under the Act.

Another example of this flexibility is the 1939 version of the Dubuque, IA FMMO. The definition of a “producer” as a “person ... who produces milk which is received at a plant of a handler from which milk is disposed of in the marketing area...” does not distinguish Grade A milk from manufacturing milk. Neither does the handler definition, which specifies that a “‘handler’ means any person who engages in such handling of milk, which is disposed of as milk or cream in the marketing area.” Again, there is no reference to Grade A milk or health inspection.

From this background, it is reasonable to conclude that regulation of all plants purchasing milk in California and all milk purchased by them from California producers would fall within

the scope of the law. The cooperatives' proposal would regulate only the purchase of Grade A milk.

The focus of existing FMMOs is regulating the purchase and handling of Grade A milk, which is presumably available for Class I use. This has been the history of the program. In the beginning, many orders operated individual handler pools, meaning that the primary uses of producer milk were for fluid milk and cream products. Producers received a "base" price and/or a uniform price derived primarily from those uses. Orders with market-wide pools exhibited these same characteristics. A producer participated in the pool only if he shipped to a fluid milk processor.

Over time, conflicts arose between Grade A producers who shipped to a fluid processor, and Grade A (or potential Grade A) producers who wanted access to the higher pool price. The dairy program administration gradually adapted by accommodating supply plants, relaxing pool qualification standards, and eliminating individual handler pools. This process, in effect, accomplished the regulation of nearly all Grade A milk used for manufacturing within the FMMO system.

The Cooperatives' proposal goes one step further. It essentially provides for the pooling of all Grade A milk produced and marketed within the state of California. That means that Grade A milk, no matter what product it is used to produce is included. This is well within the range of possibilities under the law.

### **The Need to Regulate all Grade A Milk**

The Cooperatives propose that all Grade A milk produced and marketed within the state be price regulated. This is necessary to assure that so-called "de-pooling" is minimized. There occur times when the "uniform" price falls below Class II, Class III, or Class IV prices. The

frequency of this phenomenon increased with the introduction of advanced pricing under FMMOs. At times this may create incentives to disassociate milk used in those classes from the pool. FMMOs have adopted rules to reduce the incidence of de-pooling. The California State Order currently prices essentially all Grade A milk, so a handler gains no advantage from de-pooling milk. It is still possible for individual producers to withdraw from the pool on an annual basis by foregoing Grade A status.

De-pooling can do greater damage in California than elsewhere because of the priority claim of quota milk to pool revenues. As is the case now under California regulation, quota milk is paid first, and the residual pool revenues accrue to all regulated milk. If de-pooling were to occur, it would reduce revenues from higher valued manufacturing uses, and reduce the uniform price for milk remaining in the pool. The Cooperatives' proposal would maintain the California practice of pooling all Grade A milk produced and purchased in the state to minimize the potential fluctuation in pay price among Grade A producers. Thus, greater uniformity and stability of actual pay prices to producers would result.

De-pooling would also promote instability in the uniform price. In any one month, one or more of the Class II, Class III and Class IV prices could be above the likely uniform price, providing an incentive for de-pooling. Thus, the amount of milk for which there is an incentive to de-pool can vary greatly from month-to-month. This could result in greater volatility in pay prices to producers.

### **Uniformity of Prices Among Producers**

The Act requires that prices to producers in marketwide pools be uniform as to all producers "irrespective of the uses made of such milk by the individual handler to whom it is delivered; subject . . . only to adjustments for (a) volume, market, and production differentials

customarily applied by the handlers subject to such order, (b) the grade or quality of the milk delivered, (c) the locations at which delivery of such milk is made to such handlers, and (d) a further adjustment . . . among producers and associations of producers, on the basis of their marketings of milk during a representative period of time . . .” The Cooperatives’ proposal fulfills these requirements.

The question of “uniformity” has been interpreted in many ways in the history of the FMMO program. In the days of individual handler pools, producers were paid uniformly by each handler. However, there was little or no uniformity of prices between handlers because of different utilization. Some FMMOs, such as the Washington, D.C. order, did not set prices for “surplus” milk, but pooled whatever revenue the handler in question received for his “surplus” milk, with the caveat that it not be less than the offering price of the Maryland and Virginia Milk Producers Cooperative Association. Thus, the manufacturing portion of the “uniform” price could differ for each handler. In addition many early FMMOs included what were referred to as “base” plans that assigned a higher value distribution to each producer who earned “base.” Some producers had more “base” than others, so they were paid more. Another variation came from seasonal incentive plans, such as the so-called Louisville Plan, where some pool money was withheld in the spring months and paid out in the fall months in an effort to reduce seasonality of milk production. Also, new producers in many orders were paid a lower price until they became established in the market. So, historically, there have been many instances of variations in prices paid to producers.

These variations in pay prices were gradually reduced as individual handler pools were eliminated, “base” plans grew out of favor, and minimum class prices were harmonized across orders.

The Cooperatives' proposal does include some of its own variations in producer prices. The first is the distribution of pool revenues to "quota" and "over-quota" milk. Owners of California quota have a priority claim to pool revenues, just as "base" producers did in the past. This priority distribution is required by California law. The 1996 and 2014 Farm Bills support this practice by authorizing any California FMMO to "recognize quota value." The residual pool revenues accrue uniformly to all other producers whose production is not fully covered by quota. This uniformity is greater than exists in other Federal orders because there would be no producer location adjustments.

**Will Manufacturing Milk Prices in California Be Too High?**

Under the Cooperatives' proposal some of the prices for manufacturing milk in California will be higher than they have been in the past. Will they be too high? The prices proposed are the same prices that are paid by other handlers in other FMMOs. Some of the handlers affected by these prices, today, are located in the western region of the U.S., and are subject to similar economic forces as California handlers. Western cheese makers located outside of California and Idaho (both states outside the FMMO system) have grown at a faster rate than California cheese makers (see the table below).

Cheese Production, California and Other Western States (Less Idaho), 2000 and 2014

<u>Year</u>	<u>California</u>	<u>Western States, Less CA and ID</u>
	<u>(million pounds)</u>	
2000	1,494	852
2014	<u>2,444</u>	<u>1,634</u>
<u>% Change</u>	64	92

Source: Dairy Products, Annual Summary, 2000 and 2014



These data imply that FMMO Class III prices have not been detrimental to the growth of the cheese industry in other western states.

Evidence exists that the minimum prices paid by handlers outside of California are not too high, as exhibited by their ability and willingness to pay producers substantially more than minimum blend prices. Several years ago, I asked the FMMO 30 Market Administrator to compare actual gross pay prices to producers, to minimum blend prices in each county, sorted by degree of competition in the county. He did this first for F.O. 30, and later for all markets. The results for all “competitive” counties are shown on “Table 2,” a document prepared by the Market Administrator’s Office for the months of May and December, 2008 through 2011. I offer this document as an exhibit.

Each “competitive” county listed in “Table 2” has sufficient competition by regulated handlers to render a HHI (Herfindahl – Hirschman Index) of .33 or less. I chose the HHI index represented in the table.

The price difference reported in the last column is the gross pay price to each producer, compared to the minimum FMMO price, at test for the same producer. Hauling charges were not deducted from either price.

Here are the extreme differences for each state:

<u>State</u>	<u>Smallest Overpayment</u>	<u>Largest Overpayment</u>
Iowa	\$0.25	\$3.90
Illinois	\$0.49	\$1.21
Indiana	\$(0.44)	\$1.28
Kentucky	\$0.39	\$2.19

<u>State</u>	<u>Smallest Overpayment</u>	<u>Largest Overpayment</u>	<u>(continued)</u>
Maryland	\$0.06	\$0.48	
Michigan	\$(0.43)	\$2.29	
Minnesota	\$0.81	\$1.75	
North Carolina	\$0.11	\$3.90	
New York	\$0.61	\$1.61	
Ohio	\$(0.67)	\$3.73	
Pennsylvania	\$0.49	\$2.21	
Tennessee	\$0.72	\$1.74	
Texas	\$(0.72)	\$1.19	
Virginia	\$(0.10)	\$2.08	
Wisconsin	\$0.19	\$2.21	

In some competitive areas, such as the Upper Midwest, farm-to-plant hauling costs are subsidized by the handler. Such a subsidy would increase the apparent overpayment relative to the FMMO minimum prices.

Factors other than competition also affect a handler's ability to pay. One is economies of scale. The milk in California is processed into butter, powdered milk, cheese and whey in larger plants than is the case for the rest of the country. Here is a comparison for cheese and butter:

Production Per Plant of Cheese and Butter in California and the Rest of the U.S., 2014

	<u>Cheese</u>		<u>Butter</u>		<u>(Million Pounds)</u>
	<u>CA</u>	<u>US -CA</u>	<u>CA</u>	<u>US-CA</u>	
Production	2,313	8,789	634	1,229	
No. of plants	64	466	14	72	
<u>Production/plant</u>	36.1	18.9	45.3	17.1	

Source: Dairy Products, Annual Summary, 2014

A third factor is the provision of producer services, such as field service, producer record keeping, communications, milk testing, and producer milk transportation. Here is some data:

Average Milk Production Per Producer, U.S. and California, ~~2011~~ 2014

United States:	4.5 Million Pounds
California	28.5 Million Pounds

Source: Milk Production, USDA, February 2015

Larger producers mean lower costs of these services per hundredweight of milk.

A fourth factor is the cost of balancing services for the fluid market. Since the seasonality of fluid demand does not harmonize with the seasonality of milk production, the handlers that service the fluid market suffer a loss of plant capacity utilization. The California market has a lower Class I utilization than any FMMO market, other than maybe the Upper Midwest, so there is less “give-up” cost incurred by California milk manufacturing plants.

A fifth factor is California’s proximity to Asian export markets. When export prices for dairy products rise above domestic prices, California (and other West Coast) processors can use their geographic proximity to serve those markets. They may capture higher prices, which may only be partly reflected in national average dairy product prices that are used in FMMO class price formulas. Their revenue opportunities rise more than their manufacturing class prices.

A sixth factor is that manufacturing class prices are based on basic commodity products: bulk butter, bulk cheddar cheese, bulk dry whey and bulk nonfat dry milk. These are typically lower valued products, and their prices are viewed as indicators of national supply and demand conditions. However, dairy manufacturers have a choice of making these products, or of producing higher valued products, such as retail butter, specialty cheeses, whey protein

concentrate, and customized milk powders. These represent opportunities for manufacturers to enhance their revenue stream, without increasing milk costs through regulated milk prices.

Thus, it is not likely that the proposed prices for manufacturing milk will be too high.

### Class I Differentials

The level of Class I differentials proposed will be discussed by another witness. I will comment only on the purpose and function of Class I differentials. In the early days of FMMOs, especially with individual handler pools, Class I differentials provided revenue for creating an incentive for the production of Grade A milk, and for delivering it to a fluid processing plant. First, a plant with a relatively high Class I utilization could justify paying more than other plants. Second, the extra revenue created by the differential would offset the added costs of maintaining Grade A production status of the dairy facility, and third, location adjustments encouraged the delivery of milk to urban areas where most fluid milk plants were located.

However, with the adoption of market-wide pools, there was a lesser incentive to ship to the highest utilization plant; but producers only needed to ship milk to a regulated plant, whether it be a manufacturing plant or a fluid plant. It was up to the manufacturing plant operator to satisfy pooling standards, and remain an attractive market for Grade A milk. The Class I differential was no longer sufficient to attract milk to fluid plants. However, its contribution to the uniform price usually remained sufficient to attract more and more Grade A milk to the market.

differentials

So, the level of the Class I ~~differential~~ is not the primary determinant for assuring that milk gets to the fluid plants that need it. A producer gets the uniform price no matter what product his milk is used to produce.

Proposal No. 1 imitates the California program with regard to shipping requirements. There are none. However, the California program has a latent call provision, which could require reluctant suppliers to sell milk to fluid processing plants. In my experience, this provision was never invoked.

Other factors contribute to an orderly supply of milk for Class I use. Most important are the contractual relationships between suppliers and Class I buyers, both of whom may operate on a regional or national basis. They agree to sell and/or buy milk for Class I use on terms that satisfy their business needs. These contracts exist outside the FMMO system, but provide assurance that milk will be available for Class I use.

In the California system, and in the Cooperatives' proposal, the Class I differential is the most lucrative source of funds to pay dairy farmers. Higher Class I differentials mean that quota and transportation credits will be paid and a higher residual uniform price will be available to producers, and lower Class I differentials mean a lower residual uniform price.

As argued above, Class I differentials do not provide an adequate incentive for attracting milk to a fluid processing plant. In the Cooperatives' proposal, transportation credits are an important mechanism for facilitating the movement of milk to fluid processing plants located in urban areas. Milk shipped from the farm to a qualifying fluid processor is eligible to receive a partial reimbursement from the pool for the cost of the haul.

If, for whatever reason, fluid processors have difficulty attracting enough Grade A milk, they can pay more than minimum FMMO prices for it, which is a customary practice throughout the FMMO system.

## Orderly Marketing Conditions

One of the primary goals specified in the Act is to “establish and maintain orderly marketing conditions.” “Orderly marketing” is not specifically defined in the Act; furthermore, the term “disorderly marketing” does not appear in the law. However, the Act does explicitly give the Secretary of Agriculture tools to create “orderly marketing conditions” in FMMOs. I will try to offer some perspectives on these terms. One aspect of orderly marketing conditions is stability. To me that means that the economic environment under which producers and handlers transact business does not vary as an artifact of regulation. For example, evidence will be introduced that the cost of milk for manufacturing varies widely between the California state program and the Federal program. That means that sometimes it may be more profitable to process milk under one regulatory program than the other. Firms regulated under both programs compete in the same national input markets (with the exception of raw milk), and output markets. The economic environment may be distorted merely by differences in the regulations. Orderly marketing can be improved for California producers. They compete in the national market for farm inputs, but experience significantly different prices for milk due to regulation. Another aspect of orderly marketing is efficiency. By this I mean, “Does the regulatory program simulate a competitive economic environment?” If it does, transportation and transaction costs will be lower; the most favorably located producers will associate with the most favorably located plants. Furthermore, the appropriate amount of milk will go to the most valuable uses. Whether or not a competitive economic environment is fostered is a difficult question to answer. But we can strive to achieve efficiency in developing regulations. I believe the Cooperatives’ proposal for a FMMO in California will embody both stability and efficiency.