

Testimony of Timothy E. Galloway

Class I and Class II Price Hearing

December 2006, Pittsburgh

Introduction

My name is Timothy E. Galloway. I am CEO of Galloway Company located in Neenah Wisconsin. Galloway Company is a third generation owned and managed family business. We manufacturer concentrated fluid dairy ingredients used in further food and beverage processing. Specifically we make sweetened condensed milk, ice cream mixes and beverage bases that are all considered Class II products. Therefore the majority of my comments below will pertain specifically to Class II issues. Galloway Company purchases raw milk, year round, from a number of cooperative and proprietary handlers in our area. Our finished products are sold nationwide. Galloway Company currently employs 70 people. Due to our number of employees and yearly dollar turnover we are considered a small business under the Act. We are audited by Federal Order 30.

Background

As noted above, Galloway Company products are all considered Class II. We have a choice of dairy ingredients to make our products – we can use Class II milk, use Class II milk and separate and condense it into useful components, use Class II components

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purchased from Federal Order sources, or we can use components from non-regulated sources. Similarly, our customers have a choice for their dairy needs either buying our Class II dairy ingredients or buying Class IV or unregulated dairy components to make their products. When the cost of my Class II ingredients gets too far out of line with what can be purchased from Class IV or unregulated sources, and my customers, may switch to the cheaper source – not due to issues of quality or service but due to inequities in regulated prices. When my customers switch they often have to install specialized equipment to handle hydration, melting, blending, pasteurization, homogenization and the like. This equipment needs to be paid for, so once the decision has been made it is permanent – they don't switch back.

Let me illustrate. In 1995 the Agriculture Statistics Board of USDA reported that there was a total of 157,559,000 pounds of bulk sweetened condensed whole and skim milk produced in the United States. Ten years later in 2005 the same agency reported that there was 91,907,000 pounds of sweetened condensed whole and skim milk produced. In fact, almost 15,000,000 pounds was lost during 2004. I have been selling sweetened condensed milk since 1980 and testifying at hearings since 1990. I believe I know why this dramatic decline of more than 30% has taken place. It is because unwise classified pricing disparities between ingredients in Class II and ingredients in Class IV, or from unregulated areas, grew to a point where major users decided to make a switch - and never came back. I know of a number of confectionary companies which formerly used Class II sweetened condensed milk, but now use milk powders and butter type products to make their confections. Of particular note one customer made that switch during 2004

which was the largest component of the loss mentioned above. Not surprisingly this switching has happened over a time span where the differential between milk for Class II and milk for alternative ingredients has grown from \$0.30 over the BFP, to the disastrous Class IIIa program, to the current \$0.70 cwt over Class IV skim.

Galloway Company is also a large producer of ice cream mixes. We are the manufacturing partner for Classic Mix Partners LLC, which is a joint venture with Foremost Farms USA. I must state, my testimony today represents the views of Galloway Company and not necessarily those of Foremost Farms USA. Ice cream can be made with fresh cream and condensed skim milk from Federal Order sources, or it can be made with those ingredients from areas not regulated by the Federal Orders like California, or it can be made from Class IV ingredients like NFDM and anhydrous or concentrated milk fat. In May 2000 I testified at the Hearing regarding proposed changes to the final rule that I knew ice cream mix competitors were using non-Class II fat sources during the extremely high and volatile butter prices of 1997 and 1998. I can now testify that this occurred again during the butter price run-up in 2001 and 2004-5. It will continue to occur whenever Class II ingredients get further out of line with alternative ingredients.

Galloway Company also produces non-standard of identity beverage bases that contain some dairy components. Here too we have no problem using alternative ingredients that provide better value if Class II ingredients get out of line with historical differences.

Although I do not make other Class II products I believe that the ability, and desire, to substitute Class IV or unregulated ingredients for high priced Class II ingredients is the same for all other Class II products.

What's baffling to me is that the proponents of this proposal claim they want to raise the blend price for producer milk. Yet this proposal would create a greater discrepancy between Class II, and Class IV and unregulated ingredient prices. As shown in the examples above, this will undoubtedly reduce blend dollars available from Class II as end users will substitute Class II fluid ingredients with Class IV and unregulated ingredients. Milk not used to make Class II products will have to fall into Class III and IV uses as the data indicates Class I continues to contract in volume. Additional production in Class III and IV will create additional surplus which will drive down prices which leads to less blend money. In addition, less Class II demand will cause less competition for milk between handlers and therefore smaller farm premium dollars.

What's even more baffling is that this proposal admits that NMPF supported the recent proposed changes in Class IV and III make rates. That proposal will depress farm income and raise Class III and IV processors' income. This proposal will do the opposite – it will raise farm income and reduce Class I and II processor income. Could this result be due to NMPF members having more assets tied up in Class III and IV processing, thereby more to gain, and less assets in Class I and II, thereby less to lose? Apparently what is good for the goose is not good for the gander.

Comments related specifically to the NMPF proposal

Emergency Consideration

Having the perspective of testifying at many national hearings over the years I would contend that the scope of the considerations involved in changing well established price relationships between milk Classes, blend prices within and between Federal Orders, and appropriate values for Class I and II make rates and differentials are too complex to be properly addressed in an emergency hearing.

The proponents indicate that they have repeatedly tried to point out that proposed changes in make rates for Class IV and III will affect Class I and II - as if this was an unintended consequence. Far from an unintended consequence - this is just what was expected when Class II was tied to Class IV under the current rule. During the many years and hearings that established the current rule it was determined that there needed to be this direct tie between the classes. As noted above, and further discussed below, the exact same factors that determine the make cost for Class IV products are the factors that determine the make cost of Class II products. As Class II manufacturers can alternate between Class IV components and Class II milk or components there must be a direct tie between the price formulas to prevent disorderly marketing.

The proponents also argue that an emergency rule is required as they perceive an inability to obtain milk for Class I and II needs and to prevent increased de-pooling. I can categorically state that Galloway Company has never shut down or turned down an order because we have not been able to obtain Class II ingredients. In addition, recent changes to Federal Order 30, and similar changes to other orders, were designed to severely cut back on de-pooling opportunities. In short, we see no reason for an emergency ruling.

Undue Hardship To Producers

The proponent's state that 52% of milk pooled in Federal Orders in 2005 was Class I and II. Lets be clear – 39% was pooled in Class I and 13% was pooled in Class II. Therefore, any alleged hardship caused by retaining the current Class I and II formulas is primarily the burden of Class I. If the proposals are adopted, there will be an undue hardship on Class II processors who elect to continue to use Class II ingredients but need to stay competitive with other processors who use alternative ingredients. And, there will be an unintended further hardship to producers if the proposed changes are implemented as non-Class II substitution will cause as decrease in blend and premium income.

The Adequacy of Current Class I and II Pricing Vis a Vis Disorderly Marketing

As stated previously, Galloway Company does not have a problem obtaining Class II ingredients. The proponents don't even allege a problem with Class II – they only cite rising Class I over-order premiums. And frankly, what's the problem with increased Class I premiums if the proponents are to be taken at their word about raising producer income? What are the proponents, who I suggest supply the vast majority of the milk used in Class I, doing with those over-order premiums if not passing them back to their producers thereby raising their income? Finally the Act is concerned about providing a safe and suitable supply of milk for the bottle. I don't believe the act requires any mechanism to provide milk for ice cream, yogurt, cottage cheese, sweetened condensed milk, and other Class II products.

If there is any disorderly marketing in Class II, I would suggest that it is the declining portion of Class II milk used to make Class II products because the make cost of \$0.70 cwt. is too high by the amount of hydrating the solids. It assumes that Class II processors would convert NFDM into plain or condensed skim before blending with other ingredients and processing. In fact NFDM is often just added to the processing vessels and blended and heated with other ingredients so there is no separate hydration step.

New Class II Formulas - Skim

The proponents allege that the current formulas artificially bind Class II to Class IV milk prices. There is nothing artificial about it. As stated previously this was a conscious, deliberate and painstaking process leading up to the current rule that specifically ties Class II to Class IV. It is a clear recognition that prevents disorderly marketing by having an appropriate relationship between Class II and IV make rates for similar condensing processes.

The proponents propose a new calculation for the Class II skim value. They claim that the change merely avoids the redundant application of the cost of drying condensed skim milk. It does that but also much more. The devil is always in the details. The proposal postulates "In its simplest form, the current Class II skim milk price is calculated as: $(\text{NFDM price} \times 8.9) - \$1.2474 = \$0.70$ ". Yet the language of the order is "the Class II skim milk price per hundredweight shall be the advanced Class IV skim milk price computed in paragraph (q)(2) of this section plus 70 cents". In other words the current order is explicitly tying the Class II skim price to the Class IV skim price, not just to NFDM as the proponents would have us believe. Any changes made to the calculation Class IV directly impacts Class II. We have just had one hearing on Class IV make rates and are about to have another about the entire Class IV calculation. Class II needs to reflect whatever changes are made to Class IV.

This proposal would create a point-in-time fixed differential between the cost of NFDM and Class II skim minus their interpretation of today's condensing and hydrating costs. It does not state, as it should, that the condensing cost is dynamic and has to be the same as that which is included in the Class IV skim formula. To make condensed skim, sweetened condensed skim milk or NFDM requires the same condensing process and the same costs. It would be arbitrary and capricious for the order to allow a make rate for a process in one class that is a different make rate for the same process in another class. Otherwise, a processor in one class could enjoy a higher margin making solids in one class than making those solids in another class, or processors of the same solid in another class purely through the operation of classified pricing. This is not the intent of the Act or the current rule. In addition, the condensing costs in the proposal are not documented but merely 'industry estimates' and at the lowest end of their own reported range. We just concluded a full hearing with many documented studies on the cost of condensing in Class IV. Whatever numbers are part of the final rule in that hearing should be used in determining the Class II skim price as a function of the Class IV skim price.

In summary any changes to the Class II make cost and/or differential should be based on documented cost of condensing and be the same as that which is used as the condensing cost in the Class IV as is the clear intent of the current rule. We should also wait until there is a final implemented Class IV make rate so that the condensing costs are the same. Finally, we should make sure that it is clear Class II skim value is tied by reference to Class IV skim value so that when there is a future change in one class it will affect the other in a like manner. This is consistent with the intent of the current rule.

New Class II Formula - Butterfat

The proponents claim that butter is not a viable substitute for cream in most Class II products. That may be true when considering salted, colored, flavored butter in some very white, lightly flavored products. However, it is not true for a number of confections, ice creams, yogurts and beverages which can, and do, use other Class IV fat products like anhydrous milk fat, butter oil, buttermilk and concentrated milk fat. These products can, and are, being used to replace Class II ingredients in Class II products. I earlier testified to the wide scale replacement of Class II sweetened condensed milk in the confectionary industry. The confections still need milk fat to make them taste and perform properly. If you read the ingredient declaration of the candy it still claims some source of skim milk solids and milk fat – it just comes from a different Class. I also testified that I know ice cream manufactures are substituting anhydrous milk fat and concentrated milk fat in ice cream. Although Galloway Company uses fresh cream in our mixes, during the huge run up in butter prices in 1998 we experimented with concentrated milk fat with acceptable results.

The proponents also make the statement that if butter minus a make allowance plus a Class II differential is not appropriate, the differential for Class II fat should be the minimum Class I butter fat value. The only justification for this change is vague language about Class I and II supplies being 'complementary' and that much butterfat for Class II comes from Class I operations.

First, there is no definition or illustration provided for 'complementary'. In fact it could be well argued that many Class II products are much closer to Class IV than Class I in that they are produced close to the source of raw materials rather than the consumer, have long shelf life, and shipped great distances for distribution. For instance I have testified that Galloway Company ships all three of its product lines throughout the country. In fact we are the sole supplier of many of the products we sell because of their unique properties. And there are many other instances of hard ice cream, yogurt, and beverages that are only produced at one, or at most, several factories and yet supply the entire country.

There is no documentation to the claim of how much Class II butterfat comes from Class I sources. It is likely that much of the excess Class I fat ends up in internal Class II and IV operations of the processor. However, there are a number of Class II processors not part of Class I operations. Galloway Company makes a number of high fat products and is fat deficit from our Class II milk. In my 26 years with the firm I do not recall us buying a single load of surplus cream from a bottling facility. Our additional fat comes from butter/powder facilities or skim based cheese processors. I am aware of a number of other Class II processors who do the same.

The proponents' arguments for the proposed changes for pricing Class II fat fall well short of the mark for accuracy, specificity and rationale to require any change in the Class II butterfat formula. The current rule clearly recognizes that milk fat in Class II must be tied to the same make allowances as Class IV plus a reasonable differential.

'Constraint' and 'Incidentally Related'

The proponents argue that the recent make allowance hearing was merely about establishing a wide enough margin to cover cost. That must be a very depressing thought for the hundreds of cooperatives and proprietary plants making products such as cheese and butter who thought they were in business to make a profit. I contend the purpose of the make rate hearings were to have realistic make costs so these businesses can once again be profitable.

It is true that Class I and II products are not constrained by higher product prices to set their minimum price. But it is absolutely wrong that Class II producers are able to pass on higher costs at will to the marketplace as implied by the proponents. Instead our prices are constrained by the relationship between Class IV and Class II milk. I even have formula price customers which require us to demonstrate which ingredient selection is more cost advantageous and then make it that way. Class II products made from Class II ingredients are more than 'incidentally' related to the Class IV make allowance. As is clearly and consistently stated in the current rule, Class II milk is constrained by substitution of less costly Class IV ingredients.

Cost of an Adequate Supply of Raw Class II Milk

The proposal discusses the costs involved in supplying Class I and II milk - as if these costs only apply to those classes. In most parts of the country the milk used for each class is interchangeable as the vast majority of all production is Grade A milk. Many Class II products do not need to be Grade A. Apparently, the proponents believe that producer cost increases for Grade A status should be borne entirely by Class I and II - which, using the proponents terms, is the real perversion.

The proponents are worried that not addressing these issues will result in not having a stable supply of milk and will result in more depooling. These comments are made with no substantiation or support. I have testified that we have no problem securing Class II milk under the current rule, and that the ability to de-pool in many orders has been seriously curtailed. I have testified that there is no requirement in the Act to provide milk for Class II. Therefore there is no rationale for changing the Class II price formulas based on supply issues.

Class II Formulas Should Include Class IV Price Formulas By Reference

As clearly stated in the current rule and as testified to here today the Class IV price formulas must be referenced in the Class II price formulas. The same value for condensing in Class IV must be used for Class II as there is direct substitution between ingredients of each Class. To set a fixed point in time Class II differential without direct

reference to the Class IV make allowance would destroy what is clearly the intent of the current rule to tie the price formulas. This is particularly pertinent as we approach the Class IV make rate ballot and Class IV formula price hearing.

Conclusion

The proponent's rationale for changes to Class II skim and butterfat pricing and resulting proposed formulas are illusory, superficial, capricious, arbitrary or wrong. There is no mandate that there has to be a supply of milk for Class II products. There is no demonstration that there is a lack of Class II milk or ingredients for Class II processors, therefore no emergency. There is no substantiation of the amount of potential lost producer revenue in Class II from potential changes in Class IV make rates – a small amount at best given the low utilization in Class II. There is no showing as to why the well considered rationale of the current rule to tie Class IV prices and Class II prices by reference should be invalidated. There is no demonstration that Class II ingredients do not having the same make cost problems that affect Class IV ingredients. In short we have nothing but naked claims and the assertion of producer hardship.