NATIONAL MILK PRODUCERS FEDERATION

Testimony of Jerry Kozak
President & CEO
National Milk Producers Federation

Before

The House Agriculture Subcommittee on Livestock, Dairy and Poultry
Thursday, April 26, 2012

Introduction

Chairman Rooney, Ranking member Cardoza, members of the Committee, I am Jerry Kozak, President and CEO of the National Milk Producers Federation (NMPF), a trade organization that represents 30 dairy cooperatives with over 30,000 dairy farmer members who produce and market 60% of America's milk. I am testifying on their behalf as well as the overwhelming majority of producers all across this country.

The dairy industry has changed a great deal since current dairy policies were initially put in place. Milk price volatility has increased since the early 1980s as the government has largely removed itself from supporting the farm-level price of milk. The price of feed has become much more volatile as well since the middle of the past decade. Growing world demand for dairy products has created both opportunities and new challenges for the U.S. dairy industry as well, especially in the area of commodity volatility throughout the food chain.

These elements have resulted in a much more volatile dairy business environment in recent years, which will continue in coming years. They came together in late 2008 in a perfect storm-like situation, and resulted in the 2009 financial disaster that many of America's dairy farm families experienced. The dairy crisis of 2009 showed conclusively how inadequate current dairy policies are, not only in dealing with the unusual combination of circumstances that occurred in 2009, but in addressing less dramatic financial pressures as well.

The inadequacy of these policies resulted in National Milk's membership embarking on an extensive and inclusive grassroots process to determine how to provide the best safety net possible for dairy farm families.

The Creation of "*Foundation for the Future*"

After forming a strategic planning task force in the summer of 2009 that included representatives from member and nonmember cooperatives, NMPF's task force met with dairy producer groups from across the country to gather their input on what was needed.

Following this two-day session, the task force appointed subcommittees to address three areas: protecting producer equity, reducing volatility, and assessing the mechanics of how milk is priced. It was out of these producer-driven subcommittees (meeting numerous times over a period of 18 months) that the policy package we named "*Foundation for the Future*" evolved.

Just as multiple problems contributed to an unprofitable situation for U.S. dairy farms recently, multiple solutions are required to achieve a more prosperous future. To meet this need, *Foundation for the Future* offered a multi-faceted approach by: (1) replacing existing federal safety net programs; (2) creating a new Dairy Producer Margin Protection Program to protect against the severe and unsustainable loss of margin; and (3) establishing a Dairy Market Stabilization Program to help address periodic imbalances in dairy supply and demand.

The next step in the process was to meet with dairy farmers across the country to present the *Foundation for the Future* program, and obtain their feedback.

Over a period of 42 days, 13 meetings were held in 12 cities, from Visalia, California to Syracuse, New York, and nine other cities in major dairy areas in between. The input received from these sessions resulted in the changes to the *Foundation for the Future* proposal presented to Ranking Member Peterson.

At the end of last summer, Rep. Peterson and Rep. Simpson formulated the Dairy Security Act, H.R. 3062.

The Need to Replace Current, Inadequate Dairy Programs

The Dairy Security Act (DSA) calls for three current dairy programs to be terminated and, in their place, a new safety net program to be implemented based on the concept of managing dairy producer risk while reducing margin volatility.

The Dairy Security Act discontinues the Dairy Product Price Support Program (DPPSP), the Milk Income Loss Contract (MILC) program, and the Dairy Export Incentive Program (DEIP). Instead, DSA proposes to use the budgetary savings in the federal dairy baseline to establish the Dairy Producer Margin Protection Program, as described further in this document.

Ending the Dairy Product Price Support Program

The Dairy Price Support Program was created in 1949 as a means to help provide government support for farm-level milk prices. During most of its lifespan, the program targeted a set milk price, and then established pricing targets for federal purchases of key products, such as cheese, butter and non-fat milk powder, that would help support that milk price.

In the 2008 Farm Bill, the program was altered to support specific products, ending its focus on a singular milk price, and targeting specific product price levels. Regardless of its function, however, NMPF believes it is now time to end the DPPSP and shift resources toward a new federal safety net, for the following reasons:

1. **It supports dairy farmers all around the world and disadvantages U.S. dairy farmers.**
   The current program helps balance world supplies by encouraging the periodic global surplus of milk products to be purchased by U.S. taxpayers. As a result, dairy farmers in other countries, particularly the Oceania region, enjoy as much price protection from the DPPSP as our own U.S. farmers. Without the USDA's

Commodity Credit Corporation (CCC) buying up occasional surpluses of dairy proteins in the form of nonfat dry milk, a temporarily lower world price would affect America's competitors, all of whom would be forced to adjust their production downward and ultimately hasten a global recovery in prices.

2. **It reduces total demand for U.S. dairy products and dampens our ability to export, while encouraging more foreign imports into the U.S.**

   The price support program effectively reduces U.S. exports, by diverting some of the U.S. milk flow into government warehouses, rather than to commercial buyers in other nations. It creates a dynamic where it is more difficult for the U.S. to be a consistent supplier of many products, since sometimes the domestic industry has products to export, and at other times, the domestic industry just sells to the government.

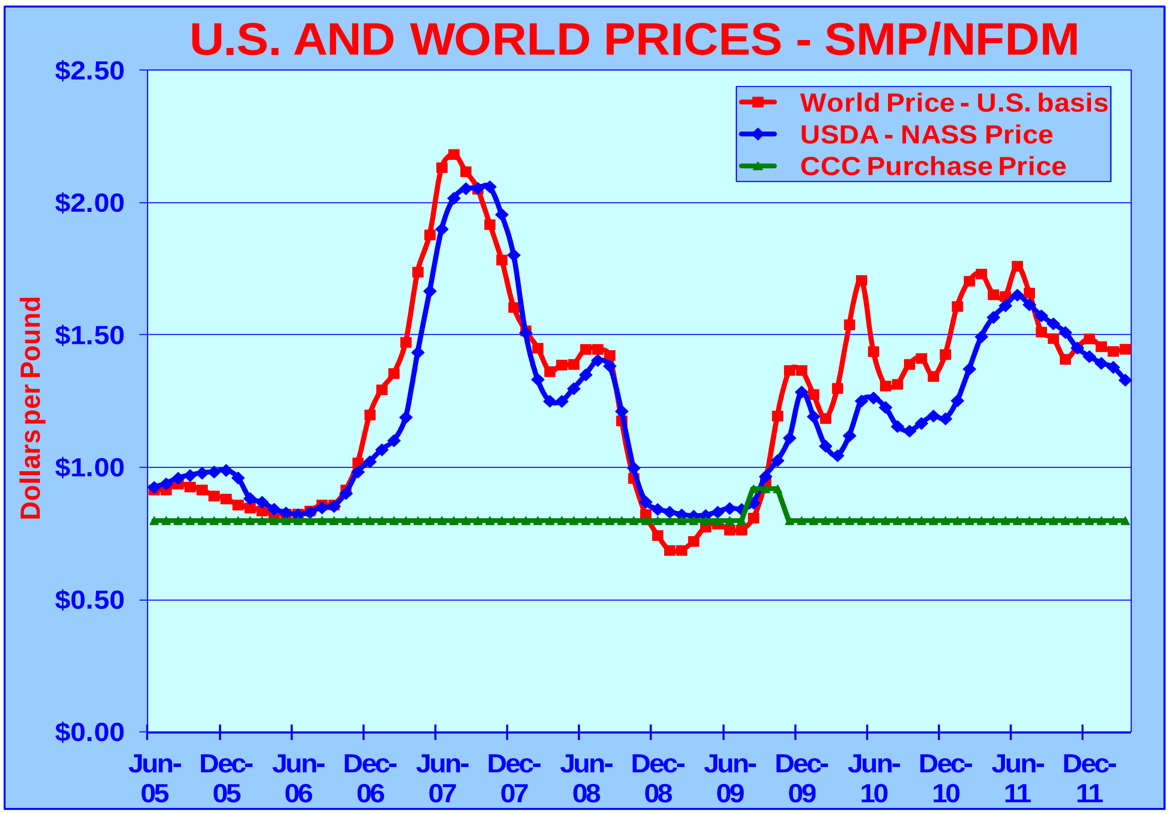
3. **It disincentivizes product innovation.**
   The DPPSP distorts what the U.S. produces – for example, too much nonfat dry milk, and not enough protein-standardized skim milk powder, as well as specialty milk proteins, such as milk protein concentrates – that are in demand both domestically and internationally.

   Because the price support program is a blunt instrument that will buy only nonfat dry milk (from among the many types of dairy powders made from milk) and because some plants have been specifically built to produce only nonfat dry milk, it puts the U.S. at a competitive disadvantage with respect to other global dairy vendors.

4. **It isn't effectively managed to fulfill its objectives.**
   Although the DPPSP has a standing offer to purchase butter, cheese and nonfat dry milk, during the past 12 years, only the last of that trio has been sold to the USDA in any significant quantity. In essence, the product that the DPPSP really supports is nonfat dry milk. Even at times when the cheese price has sagged well beneath the

price support target, cheese makers have chosen not to sell to the government for a variety of logistical and marketing-related reasons. NMPF has tried to address these problems, but the USDA shows no inclination toward facilitating greater purchases of product by recognizing the additional costs required to sell to government specifications such as specific sizes and packaging types. Once purchased, nonfat dry milk powder returning back to the market from government storage also presents challenges, dampening the recovery of prices as evidenced in **Chart 1**.

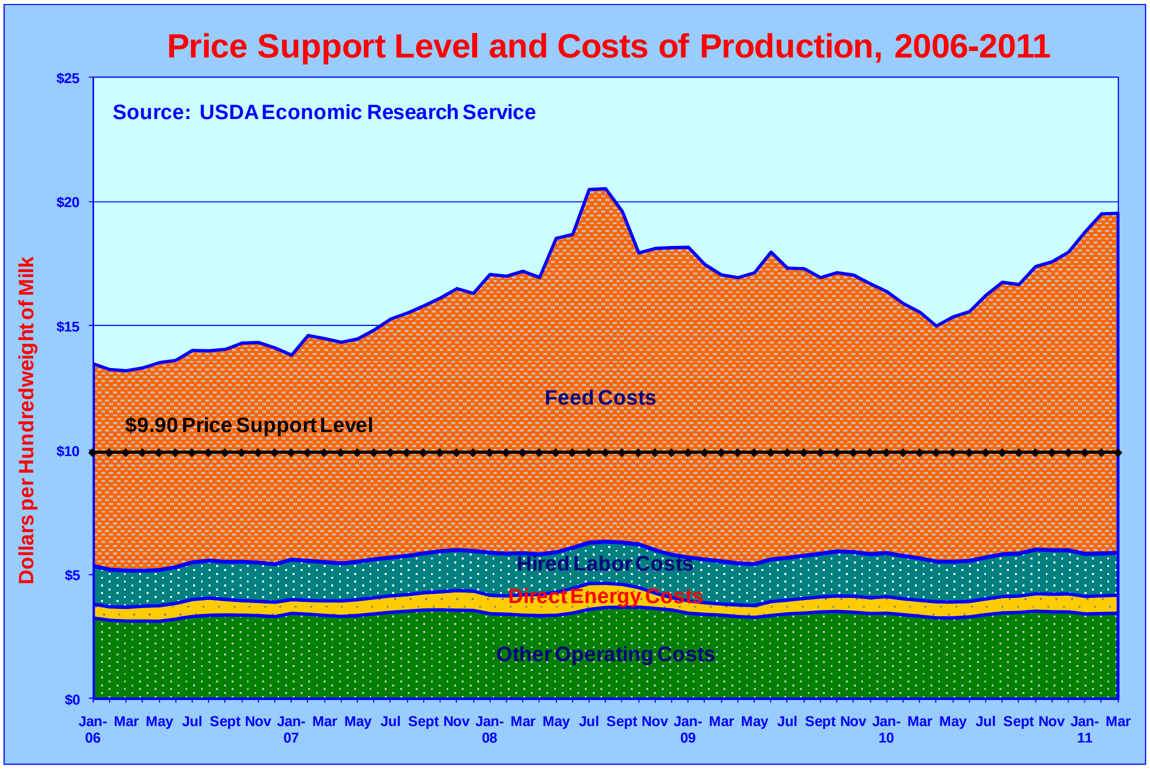
Chart 1



5. **It seeks to achieve price levels that are no longer relevant to farmers.**
   Even though the $9.90 per hundredweight target was eliminated in the last Farm Bill, the individual product price support targets – $1.13 per pound for block cheese, $0.85 for powder, and $1.05 for butter – will essentially return Class III and IV prices around $10 per hundredweight. In an era of higher costs of production, that minimal price isn't acceptable in any way, shape or form as the following chart so clearly demonstrates. As shown on **Chart 2**, the effective price support level has been

considerably less than the cost of production for many years. The government is not at all likely to raise the support prices (which would have negative consequences both for the burgeoning federal deficit, as well as our trade treaty limitations), and even if it did, the industry would likely experience continued delays in the recovery of prices when the program is most needed.

Chart 2



In summary, discontinuing the DPPSP would eventually result in better returns for U.S. dairy farmers. By focusing on indemnifying against poor margins, rather than on a milk price target that is clearly inadequate, the industry can create a more relevant safety net that allows for quicker price adjustments, reduces imports and facilitates exports. As a result of the present DPPSP, the U.S. has, in effect, become the world's balancing plant. As time marches on, so, too, must our approach to helping U.S. dairy farmers.

Ending the Milk Income Loss Contract (MILC) Program

The MILC program is a price-based safety net, which is as ineffective for today's dairy producers as the Dairy Product Price Support Program. In 2008 and 2009, MILC proved to be an inconsistent safety net program for dairy farmers facing very low, or even negative, operating margins. MILC, despite its feed cost adjustor, does not adequately offset high feed costs and its price target does not track national farm milk prices.

The triggering of an MILC payment is dependent on a low milk price. If milk prices are at average levels and feed costs are high, farmers can suffer substantial losses and still not receive any assistance from MILC. Although a feed cost adjustor was added in the 2008 Farm Bill, this program does not go into effect until the price of the National Agricultural Statistics Service (NASS) standard feed ration reaches $147 per ton (equivalent, for example, to $3.75 per bushel of corn, $9.50 per bushel of soybeans, and $130 per ton of alfalfa). It also only covers about 30 percent of the feed price increase above this high level. This was clearly inadequate through most of 2008, when high feed costs overwhelmed average milk prices and put most farmers into a deep hole without the help of any MILC payments. The current feed ration utilized in the MILC has not been sufficiently updated to reflect today's current dairy farm feeding practices. On the other hand, the Dairy Producer Margin Protection Program recommends utilizing a new feed ration reflective of the entire dairy feeding enterprise at the farm level.

The MILC target price is a Class I price. Class I is currently based on the "higher of" Class III or IV prices, so when the Class IV (butter/powder) price or the Class III (cheese) price is high, MILC payments can be low or zero, even if producers are facing low margins.

The MILC program is inequitable in its treatment of dairy farmers and, therefore, ineffective in its objective of providing economic relief to dairy farmers in their time of need. Requiring producers who market more than 2.985 million pounds of milk a year to guess in which of the coming twelve months they will most likely need economic assistance is why it is ineffective. Limiting the level of protection to a maximum of 2.985 million pounds of milk a year provides a safety net for less than 30 percent of the total milk produced in the U.S. A basic principle of the Dairy Security Act is that all farmers should be treated equally regardless of size or region.

As dairy farmers face growing volatility in both their feed costs and their milk prices, the milk price-based dairy producer programs are no longer adequate or efficient. As evidenced significantly in 2009, the MILC program does not provide an effective safety net for dairy producers. It is for these reasons that the DSA recommends discontinuing the Dairy Product Price Support Program (DPPSP) and the Milk Income Loss Contract (MILC) program in the next Farm Bill and using the budgetary savings in the federal dairy baseline to establish the new Dairy Producer Margin Protection Program as described next in this document.

Ending the Dairy Export Incentive Program (DEIP)

Intended to help expand the sales of U.S. dairy products into world markets, the program has been used instead as an adjunct to the dairy price support program. As such, it was only made available in a very limited way after the price support program began purchasing and storing dairy products.

Instead of expanding world markets for U.S. dairy products which requires a long-term commitment to serving those markets, the U.S. government has only used DEIP either in response to heavy European subsidization of dairy exports or as an alternative to storing products under the price support program. The program generates a baseline cost without providing any consistent, meaningful return to the U.S. dairy sector.

The Need for the Dairy Security Act of 2011

The Dairy Security Act replaces these three ineffective programs with two that are designed to work together to prevent the catastrophic loss of a farmer's hard-earned equity. They are the Dairy Producer Margin Protection Program (DPMPP), and the Dairy Market Stabilization Program (DMSP).

1. The Dairy Producer Margin Protection Program (DPMPP)

The Dairy Security Act's Dairy Producer Margin Protection Program (DPMPP) is intended to support producer *margins*, not prices. DPMPP is a program that is designed to address both catastrophic conditions, which can result in the severe loss of equity for dairy farmers, such as those witnessed in 2009 as well as long periods of low margins, such as those experienced in 2002.

Under this program, "margin" is simply defined as the All-Milk Price minus feed costs. Feed costs are determined by using a new feed ration that has been developed to more realistically reflect those costs associated with feeding the entire dairy farm enterprise including milking cows, heifers, etc. The DPMPP operates on the premise of providing a basic level of protection for all producers and a voluntary supplemental coverage. The basic coverage is fully-subsidized by the federal government (as was the case with the DPPSP and MILC), while the supplemental coverage is voluntary and premiums are partially subsidized by the government, but in a manner in which the level of subsidization decreases as the level of coverage per hundredweight increases.

When the margin falls below $4.00 per 100 pounds of milk for consecutive two-month periods, producers who sign up for the program receive the difference between $4.00 and the actual margin. This is paid on their actual milk production for the two-month periods the program is in effect, not to exceed 80% of one-sixth of their highest annual milk production for the three years prior to the program being enacted.

Producers will have the option of buying additional coverage above the $4.00 catastrophic level of coverage, up to an additional $4.00 per hundredweight on 90% of their prior year's annual milk production. They can also insure the annual growth, if any, in their milk output, so that if these farmers choose to expand production, they have some downside protection for that growth.

The program is voluntary. Every producer has a choice: to take advantage of the margin protection program, or not. The basic $4.00 catastrophic coverage has no premium. A producer signs up once and he/she is covered on 80% of their historic milk production for up to $4.00 of margin protection.

The DPMPP is intended to be a Title I program operated by the Farm Service Agency (FSA).

2. Dairy Market Stabilization Program (DMSP)

As a voluntary program, the DPMPP has an associated requirement – a condition of participation in DPMPP is participating in the Dairy Market Stabilization Program (DMSP).

The purpose of the DMSP program is to make what occurs naturally in the marketplace occur sooner and faster and reducing price volatility to the benefit of producers, processors and consumers. It also reduces that cost of the margin program resulting in savings compared to current dairy programs.

As with the Dairy Producer Margin Protection Program, the DMSP will be driven by margins and calculated in the same way. Under the DMSP, when the national average margin on milk drops to certain levels, producers would receive payment for the greater of a percentage of their established Base Milk Marketings or their current milk marketings. While the milk may still be picked up and processed, payment for the milk above the specified percentage of marketings would go from the processor to the

USDA, which would use the funds to purchase dairy products for food assistance programs.

Participating producers would choose whether their Base Milk Marketings would be the average milk marketed over the three-months immediately prior to USDA announcing that the program is going into effect, or the milk marketed during the same month in the previous year for each month the DMSP is in effect.

The program triggers in:

- When the national margin is $6.00 / cwt. or less for two consecutive months, producers would be paid for the greater of 98 percent of their Base Milk Marketings or 94 percent of their current milk marketings.
- When the margin is $5.00 / cwt. or less for two consecutive months, producers would be paid for the greater of 97 percent of their Base Milk Marketings or 93 percent of their current milk marketings.
- When the national margin is $4.00 or less in a single month, producers will be paid the greater of 96 percent of their Base Milk Marketings or 92 percent of their current milk marketings.

Once triggered, the program would remain in effect until the national margin exceeds the $6.00 / cwt. level for two consecutive months.

The simple fact of the matter is that dairy farmers and the cooperatives they own bear the burden of balancing the supply of milk with processor demand for that milk.
For example, during the Christmas holidays when schools are closed, dairy farmer cooperatives are the entities responsible for handling the milk that is being produced so it is available when schools start up again. Likewise, when the worldwide recession hit in late 2008, and U.S. exports of dairy products fell by over 30%, dairy producers and their cooperatives had to handle the surplus milk that suddenly appeared.

Had the Dairy Security Act been in place in 2009, producer margins would have turned around seven months sooner than actually occurred and saved billions of dollars in dairy farmer equity.

The DMSP program is entirely voluntary and its purpose is the same: to alleviate as quickly as possible the financial burden excess milk production puts on dairy farmers and dairy cooperatives.

Yes, the possibility of the DMSP program temporarily impacting dairy farmers who want the protection of the DPMPP is a condition tied to the margin protection program. And, a producer has the option of reducing milk production under the DMSP program, <u>but is not required to do so</u>.

If the farmer chooses not to reduce production should the DMSP program go into effect, then the producer is not paid for a small portion of the milk he or she marketed. That money is deducted from producer milk checks and sent to USDA to buy dairy products from processors and manufacturers for direct donation to organizations that feed the needy.

NMPF's own economists looked back at the period from 2001 to 2010 using the same DMSP provisions and found that the program would have only been activated twice in 2009. This is hardly the intrusive program opponents claim it would be.

Those same voices have argued that the U.S. will lose its ability to export under this program, and will regress into a globally uncompetitive dairy sector. As a result of discussions with trade experts and feedback from companies exporting U.S. dairy products, the DMSP incorporated a series of qualifiers that would prevent any reduction in domestic supply of milk if the US and world prices misaligned. The DMSP program is suspended not only when margins are above S6.00 for two consecutive months, but also when US cheddar or NFDM price is equal to or higher than the World price for 2 consecutive months even when margin is less than $6.00. The DMSP program is also stopped if the margin is between $5.00 and $4.00 and US cheddar or NFDM price is 5% or higher than the world price or when the margin is $4.00 or less and US cheddar or NFDM price is 7% or higher than the World price for 2 consecutive months.

Farmers who are spending millions of dollars a year funding both the Cooperatives Working Together (CWT) program and the U.S. Dairy Export Council take umbrage at that allegation. In fact, U.S. dairy farmers are aware of the importance of global marketing, and were mindful of that importance as the DMSP was developed. Some of the key principles that guided the development of the DMSP include:

- Allow for production growth. The program is intended solely to intervene in the market to address temporary imbalances between supply and demand. The program will send clear economic signals to producers if there is an imbalance in the marketplace, but it will still allow milk production to grow.

- Reduce margin volatility. The program's ultimate objective is to restore balance between supply and demand in the marketplace for milk. By encouraging producers to lower their milk marketings at appropriate times, prices will rise, thus improving margins to more reasonable levels.

- Keep government intervention at a minimum. The legislation establishing the program will set the parameters that put it into effect. USDA's role will be limited to determine the actual monthly margin and to collect potential farmers' contributions.

- Not encourage imports or discourage exports. Global and U.S. markets must maintain a strong correlation. Such correlation will allow domestic inventories to clear faster, encourage exports, discourage imports, and help ensure that market downturns are of shorter duration.

Conclusion

Mr. Chairman, Committee members, there has never been the level of consensus within the U.S. dairy producer community as currently exists in support of the Dairy Security Act. In addition to the member cooperatives of NMPF, the following organizations support the DSA:

- American Farm Bureau Federation
- National Council of Farmer Cooperatives
- National Farmers Organization
- Holstein Association USA, Inc.
- Milk Producers Council of CA and a majority of other state dairy producer associations

These organizations support the DSA because it is a package that addresses the concerns they have had regarding future dairy policy:

- The program is voluntary. Every producer can choose whether they want the protection offered by the DPMPP recognizing that they are then subject to the provisions for the DMSP program.
- The margin protection program provides participating dairy farmers with a basic safety net against catastrophic equity loss and the option of purchasing additional margin protection above the basic level.
- The DMSP program signals producers well in advance of declining margins reaching catastrophic levels and allows them to choose to adjust production, or do nothing and have a small percentage of their milk check fund purchases of dairy products for use by the nation’s food banks and feeding programs.
- DMSP contains a number of safeguards to ensure that the program doesn’t trigger in and negatively impact the dairy industry’s ability to export.

DSA also begins transitioning dairy farmers to being better able to manage their business risk in a deliberate, planned approach that provides a better safety net while reducing government involvement and positioning our industry to better compete in the growing global dairy marketplace. The program also complements private sector risk management tools, such as the use of futures markets and forward contracting. Indeed, it will help expose dairy farms of all sizes to the concept of using such tools to help better protect them from increased volatility.

Criticism of the Dairy Security Act from commercial milk buyers alleges that it will restrict milk production, raise consumer prices, and negatively impact exports. We believe these allegations are clearly ill-founded and based either on insufficiently robust or incomplete economic analysis at best or pure conjecture at worst. Additional analysis can be expected to reinforce the fact that these concerns are clearly without merit.

In addition, with respect to fears about a reduction in U.S. dairy exports, it is important to note will not restrict milk production, raise consumer prices, or negatively impact exports. It is important that the Committee be aware that America's dairy farmers have long recognized the importance of export markets. As mentioned previously, for 16 years they have funded the U.S. Dairy Export Council through the promotion deduction from their milk checks. Dairy farmers producing 70% of the nation's milk have funded the Cooperatives Working Together Export Assistance program which has invested nearly $100 million dollars since 2003 helping members sell 427 million pounds of cheese, butter and milk powders to 30 plus countries on four continents. Why would NMPF support a program that would negatively impact the investment of all those producer dollars?

The DSA changes the status quo by eliminating the current ineffective government dairy programs, and provides participating dairy farmers with a much better safety net, while reducing spending on dairy programs by precious millions of dollars in the dairy baseline.

<u>It treats all farmers in all regions equally</u>. It does not raise consumer prices nor negatively impact exports, while addressing the wild price swings that have plagued

producers and processors in the past. It allows an orderly transition to a new era whereby dairy farmers manage their risks and creates a solid safety net for farmers.

Importantly, we have to remember that protecting against the erosion of dairy farms and a domestic milk supply is critical to our nation's food security. We can't take this for granted. Off-shoring our food production is not in the best interests of our national security, but is a real possibility if we don't have better tools to manage price volatility and prevent the loss of more dairy farms.

The commodity titles of the farm bill exist to ensure that we always have the ability to feed ourselves. The dairy title should be about giving our dairy farmers the tools they need to protect and preserve their business operations so they can weather difficult times and give them a reasonable chance to continue to produce a safe and nutritious product for our consumers.

We respectfully urge you to include the Dairy Security Act in the next Farm Bill. It offers a far more responsive protection for our farmers' hard-earned equity than the system we have today. Our dairy producers deserve and need the right thing, and the Dairy Security Act is our best chance to get it right.

Thank you.