Minutes of the Dairy Industry Advisory Committee
Thursday, June 3, 2010, through Friday, June 4, 2010

A second public meeting of the Dairy Industry Advisory Committee (DIAC) was held at the USDA Jamie L. Whitten Building, Washington DC, Room 104A, on Thursday, June 3, 2010, through Friday, June 4, 2010.

Committee members present included the following:

Name	State	Business
Andrew Novakovic, Chairman	NY	Cornell University
Erick Coolidge, Vice Chairman	PA	Le-Ma-Ra Farm
Paul Bourbeau	VT	Paboco Farms, Inc.
Jay Bryant	VA	Maryland and Virginia Milk Producers Cooperative Association
Timothy Den Dulk	MI	Den Dulk Dairy Farm, LLC
Debora Erb	NH	Springvale Farms/Landaff Creamery, LLC
James Goodman	WI	Northwood Farm
James Krahn	OR	Oregon Dairy Farmers Association
Edward Maltby	MA	Northeast Organic Dairy Producers Alliance
Robert Schupper	PA	Giant Food Stores
Manuel (Ray) Souza	CA	Mel-Delin Dairy
Patricia Stroup	CA	Nestle
Sue Taylor	CO	Leprino Foods Company, Inc.
Edward Welch	MN	Associated Milk Producers Inc.
Robert Wills	WI	Cedar Grove Cheese Inc.

The following committee members were unable to attend:

James (Ricky) Williams	GA	Williams Dairy Trucking, Inc.
Rodney Nilsestuen	WI	Wisconsin Department of Agriculture, Trade and Consumer Protection

All officers from USDA were in attendance for all or part of the meeting, including:

Brandon Willis, Deputy Administrator for Farm Programs, Farm Service Agency
Serving as Executive Secretary
Dana Coale, Deputy Administrator for Dairy Programs, Agricultural Marketing Service
Serving as Alternate Executive Secretary
Solomon Whitfield, Acting Director of the Price Support Division, Farm Service Agency
Serving as Designated Federal Official

Erin Taylor, Marketing Specialist, Agricultural Marketing Service
Serving as Alternate Designated Federal Official

Thursday, June 3, 2010

Call to order and welcome, 8:30 AM

Solomon Whitfield, Designated Federal Official, called the meeting to order. Chairman Andrew Novakovic welcomed those in attendance at the meeting and briefly discussed the agenda.

Chicago Mercantile Exchange (CME) Price Discovery and Reporting,
Paul Peterson, CME Group, Inc.

Paul Peterson briefly discussed the history of the CME from its start as the Chicago Butter and Egg Board in 1898 to the present. A variety of dairy contracts are traded on the CME, covering both spot cash markets as well as futures and options markets for certain dairy products and Class III and Class IV milk. He explained that a standard contract is for 200,000 pounds of milk (there are also 50,000 and 100,000 pound contracts available) and monthly contracts can go out as far as 24 months. Brokerage fees are on a per contract, not a per pound, basis.

Dr. Peterson explained that cash settlement contracts were found to be more useful than physical delivery contracts. This relates to the importance that the industry places on using these contracts for price discovery, not actual procurement or sales. He explained that spot cash markets are used to fill short term needs and estimated that transactions on the spot cheese market equal approximately 1 percent of total U.S. cheese production.

Dr. Peterson explained that there has been growth in open interest for futures and options with options having greater open interest than futures. He discussed briefly how hedging works, providing examples. Dr. Peterson stated that USDA price announcements are vital to the CME given that many of the CME futures contracts are settled against prices announced by USDA, and by doing so it minimizes basis risk for the hedger.

Allegations periodically arise that CME prices have been manipulated. Dr. Peterson explained that the dairy industry relies heavily on CME prices as a benchmark for establishing dairy product prices. Therefore, CME prices affect minimum prices for milk set by the Federal Milk Marketing Order (FMMO) system. CME prices for butter and cheese are used directly to establish minimum prices set by the California milk marketing order system. He stated that the CME has never condoned the use of its markets for anything other than its stated purposes, and it is not clear to him that CME prices represent equilibrium prices for dairy products. He pointed out that, as far as he knows, dairy prices are the only agricultural prices where the prices of the inputs (milk) are established based upon the prices of final products (cheese, butter, nonfat dry milk and dry whey).

Dr. Peterson explained that transactions on the CME are monitored by the CME's Market Regulation Department and also regulated by the U.S. Commodity Futures Trading Commission (CFTC). Buyers and sellers identify themselves to the CME each day, and the Market Regulation Department monitors trades for suspicious market activity. The CFTC has explicit responsibility for overseeing futures markets. Since spot market transactions affect futures markets, CFTC also has responsibility for overseeing spot markets. Dr. Peterson said that a 2007 report by the U.S. Government Accountability Office (GAO) found no evidence that prices on the CME were being manipulated.

Dr. Peterson asserted that speculators serve an important role in the market by providing liquidity. He indicated that a speculator stands ready to buy and sell when two hedgers might not be ready to do business together at stated prices. In the absence of speculators, the market would be thinner and price movements would not be as smooth. In accord with conventional theory, he believes that speculators dampen rather than magnify volatility.

In response to questions, Dr. Peterson stated that even if USDA started using a competitive pay price, CME contracts would still settle against that competitive price. When asked if there is a way to increase trading on the CME, he replied that the CME is open every weekday, but trading continues to be flat.

Various members also asked Dr. Peterson about the impact of various industry proposals on the CME and if he has an opinion on any current proposals. Dr. Peterson stated that he has no opinion on any proposals, but that the CME will adapt to whatever changes that may occur via the Farm Bill.

Another member asked how the CME decides what contracts will trade and the contract specifications. Dr. Peterson said the CME holds a yearly forum to get ideas and feedback from industry participants on opportunities for new products and what changes could be made to existing products. Additionally, he said the CME has an employee who is responsible for evaluating the performance of current dairy-related products offered by the CME as well as product development.

Break, 10:00 AM

NASS Dairy Price Statistics,

Joe Gaynor, National Agricultural Statistics Service (NASS), 10:30 AM

Joe Gaynor explained that NASS began reporting cheese prices in 1997 and prices for butter, nonfat dry milk, and dry whey in 1998. These price surveys were requested by USDA's Agricultural Marketing Service (AMS) for use in FMMO product price formulas.

Mr. Gaynor explained the process NASS uses to determine the eligibility of plants for participation in their surveys. NASS screens operations based on the commodities produced and the specifications of those products. During the plant visits, NASS works with the plants to assure an orderly process for collecting survey data. He said that NASS finds out about new plants through several means, including newspaper articles and contacts with State governments. New plants may be added to the survey at any time during the year. Mr. Gaynor also explained the general specifications for products that are included in the survey. He also said that prices reported by NASS are weighted average prices. Mr. Gaynor estimated that NASS surveys plants that account for approximately 36 percent of U.S. cheddar cheese production.

NASS checks data that it receives for reasonableness. This is done at three levels: (1) by NASS field offices, (2) by Mr. Gaynor, and (3) by Mr. Gaynor's supervisor. NASS addresses questionable reported data by contacting and verifying the information provided by the individual responsible for filling out the survey or by requesting a special verification by AMS.

Mr. Gaynor said that NASS takes great care to assure that proprietary survey data remain confidential, as required by law.

A DIAC member asked if there could be imported milk inputs reflected in NASS survey results. Another DIAC member stated that NASS surveys products that have a Food and Drug Administration Standard of Identity and current Standard of Identity regulations limit the use of imported dairy components. This reduces the likelihood of imported product data appearing in NASS survey results.

NASS Verification Program, John Mengel, AMS, 10:45 AM

John Mengel explained that the NASS Verification Program began in August 2007 under an interim rule and that a final rule was issued in June 2008. The verification program is for price reporting of cheddar cheese, butter, nonfat dry milk and dry whey. AMS auditors follow procedures provided in a Verification Program Manual. The verification program is coordinated through the Minneapolis FMMO Administrator's office. Eight Market Administrator offices have access to the data through secure electronic encryption. When verifying data, auditors usually examine the most recent five weeks of data, but they may examine data for the previous two years.

Mr. Mengel said that during the first year of the verification program, auditors visited every plant. After the first year, larger plants are visited each year, and smaller plants are visited every other year. The larger plants account for approximately 80 percent of the sales volume reported to NASS. At times, AMS performs special verifications due to data anomalies. Over time, AMS auditors have seen a marked decrease in the number of reporting errors.

A DIAC member asked if the Department had an estimate of the costs to the industry of reporting prices to NASS for the Dairy Products Prices Report. USDA indicated that such estimates are required under federal law, but the specific estimate was not known at that time. This information will be provided to the DIAC members.

Cornerstone for Change: Market Transparency and Price Discovery,
Dairy Policy Action Coalition (DPAC), 11:20 AM
Rob Barley, DPAC Vice Chair, Star Rock Farms
Dennis Wolff, DPAC Government Relations Consultant, Versant Strategies

Rob Barley explained that DPAC's membership consists entirely of dairy farmers. According to Mr. Barley, steps should be taken to minimize the influence of the CME on prices received by dairy farmers.

Dennis Wolff explained that DPAC advocates mandatory daily electronic reporting of prices paid for selected dairy products and quarterly audits. He said that current NASS price reports contain data that is up to 14 days old. He stated that the 2008 Farm Bill contains provisions for electronic reporting and quarterly audits pending funding. He said that DPAC has had several meetings with the House and Senate Agriculture Committees and with USDA concerning this issue. According to Mr. Wolff, the estimated costs would be around $1 million to design and implement a program similar to what is now done in the hog and beef industries. He said a letter has been sent to the Agricultural Appropriations Committee asking for the funding to be considered. DPAC also believes that there should be an expansion of price reporting to include more products.

Mr. Wolff explained that DPAC has two primary goals: to increase competitiveness and to improve transparency. Mr. Wolff explained that DPAC advocates replacing the Dairy Product Price Support Program (DPPSP) with a program that provides recourse loans and grants. He is of the opinion that the DPPSP does not encourage innovation because it guarantees a minimum price for standard commodities. DPAC would also like a simplified FMMO system that would involve converting to two classes of milk and moving to a competitive pay price system.

Mr. Barley reiterated that dairy policies need to be simplified and that current policies encourage "gaming of the system."

A question was asked if DPAC would support any changes to the DPPSP instead of its elimination. Mr. Wolfe said that program purchases should be only for those products with actual market outlets, such as skim milk powder. He acknowledged this would create problems for plants in California that have invested heavily in nonfat dry milk production, but there could be money set aside to help these plants make the transition.

A few members asked if the DPAC proposal would have an impact on milk prices and price volatility. Mr. Wolfe replied that it would not increase milk prices, but could reduce volatility because people would have a better understanding of current market conditions. Mr. Wolfe indicated that DPAC has not conducted any specific research on the impact of their proposal, but they have talked to many dairy economists and taken their suggestions into account. Another DIAC member asked if daily instead of weekly reporting could cause more confusion because there could be more price revisions. Mr. Wolfe believed that this should be minor and stated that reporting plants would need to implement a system for accurate reporting.

Lunch, 12:00 noon

Public Comment Period

Sarah Blood, Agricultural Committee Director, New York State Senate (representing New York Senator Darrel Aubertine), 1:00 PM

Sarah Blood read a letter from New York State Senator Darrel Aubertine, who chairs the State Senate agriculture committee. The letter addresses the difficult situation currently being experienced by dairy producers, with prices received by dairy farmers being below the cost of production for several years. At the same time, processors have been receiving record profits. He calls for enforcement of existing anti-trust laws to prevent "mega-mergers" that are forcing vertical integration of American agriculture. He points to a link between energy independence and national security and notes that a similar link exists between food independence and national security. He states that farmers are not begging for Federal handouts but that they want the government to take their side in the global marketplace.

Kathy Ozer, National Family Farm Coalition (NFFC), 1:20 PM

Kathy Ozer stated that many dairy farms are on the brink of collapse as financial institutions are taking liquidation steps. According to Ms. Ozer, there has been a tightening of farm credit. NFFC believes that farmers should be paid enough to cover their costs of production. Ms. Ozer discussed the $50 million loss to farmers as a result of misreporting to NASS. NFFC believes that dairy farmers should be compensated for this loss. Ms. Ozer urged the DIAC to pay close attention to the public hearings by the Department of Justice and USDA. NFFC supports Senate bill 1645 sponsored by Senators Specter and Casey (Specter-Casey bill). Ms. Ozer stated that her written statement would provide more details and analysis concerning the bill. (No written statement was provided to the DIAC at the meeting.)

Return to Competitive Pay Pricing for FMMO Class II-IV Milk Pricing Formulas, 1:30 PM
Walt Whitcomb, Board Member, Maine Dairy Industry Association (MDIA)
Paul Christ, Dairy Consultant
Dan Smith, Attorney

Walt Whitcomb, a Maine dairy farmer, stated that MDIA is comprised of dairy farmers who sell commercially in the State of Maine. The organization is funded by assessments of $0.01 per cwt from each farmer, with some farmers voluntarily contributing more. MDIA is sponsoring a proposal for the FMMO system to convert to a competitive pay price system.

Dan Smith stated that MDIA is interested in finding solutions under current law. They believe that the dairy industry can reach a consensus concerning a competitive pay pricing system for FMMOs. He stated that as a trade organization, MDIA does not market milk, so they are not vested in any particular element of the dairy foods industry.

Paul Christ presented a proposal for a competitive pay price system based upon unregulated prices for farm milk in areas where there is substantial competition for milk. He suggested two options for measuring competition: the number of milk buyers per county; or a Herfindahl index of market shares for milk buyers per county. Mr. Christ explained that the Herfindahl index is calculated by squaring the market shares of each of the buyers in a market, and then summing the squares. A larger Herfindahl index number signifies greater concentration. Mr. Christ indicated that by either measure, the areas of greatest competition for milk in the U.S. are located in the Upper Midwest and the Northeast.

With the system proposed by Mr. Christ, there would be two separate pools. He explained that the first pool would be comprised of counties with five or more handlers competing for milk. In these areas, buyers would not be required to pay minimum prices to producers and the pool would pay a rolling 12-month average producer price differential (PPD) to producers. The total price received by farmers for their milk would be the open-market competitive price they receive from their buyer plus the month's PPD. Mr. Christ further explained that this proposal only deregulates payments to producers – handlers would still be required to account to the pool at classified prices from which the rolling average PPD could be paid.

Mr. Christ explained that the second pool would include all milk purchased outside the competitive areas and would operate exactly as the current FMMO pool. The only difference would be that the basic formula price would come from the competitive pools, and not from a complicated end product formula price.

Mr. Christ explained that there is a difference between the MDIA proposal and proposals being considered by the National Milk Producers Federation. He explained that MDIA wants to deregulate pricing in selected counties for all milk sold in those counties; as opposed to deregulating all milk purchased, regardless of location, by a particular type of plant.

A DIAC member asked what the impact would be to producers. Mr. Christ was of the opinion that producers in unregulated areas would be about as well off as they are today, but thought that producers in regulated areas would be a little better off.

Dairy Farm Risk Management, Bill Curley, Blimling and Associates, 2:30 PM

Bill Curley stated that price volatility is not well defined or understood by many people. He stated that there are two means of dealing with it: through a policy framework or through market-based tools. Mr. Curley believes that it is important to distinguish between milk price variations that are predictable versus those that are unpredictable. He argued that much of the volatility that we have seen in the dairy industry has been predictable.

Mr. Curley listed several price-swing triggers:

- Weather issues in Oceania –*a true shock*
- Emotion: fear of shortages/fear of surpluses –*somewhat predictable*
- Reformulation to avoid high priced dairy ingredients –*predictable*
- Incentives/Disincentives created by public policy –*predictable*
- Recession –*somewhat predictable but the magnitude was a shock*
- Flawed price discovery vehicles –*predictable*

Mr. Curley discussed the effectiveness of risk management tools currently available. He noted that while there has not been much participation in CME spot cheese and butter markets, there has been increased participation in futures markets. He presented a graph depicting a forward contracting program that his firm managed, indicating that price swings had been significantly diminished for contract milk in comparison to the Class III price. He said that those participating in the program paid about $0.16 per cwt, but as a result of forward contracting, they were never faced with receiving $9 per cwt for their milk.

Mr. Curley believes that dairy policy is contributing to price volatility, such as that seen in the past two years. He stated that long-term solutions should not be based on short-term problems.

A DIAC member commented that Mr. Curley makes the assumption that producers can be responsible for the disposal of their production. Mr. Curley stated that a problem is that producers do not know if their cooperatives have a customer for their milk – they just know that the cooperative will make it disappear. He concluded that this creates production where there is no buyer. The DIAC member was of the opinion that the problem is created because processors look at plant capacity rather than product sales.

Another DIAC member questioned whether the current strong U.S. dollar would spur production. The member was of the opinion that the U.S. needs to have a lower cost of production to be a real world market player. Mr. Curley was of the opinion that the U.S. dairy industry is not very serious about servicing the export market. He said that companies try to trade below world market prices, but they still cannot get the business. He said that these export decisions are not based solely on price.

Break, 3:00 PM

Subcommittee A Report and Discussion, Options Under Current Law,
Paul Bourbeau, Chairman, 3:40 PM

Subcommittee Members: Paul Bourbeau, Rod Nilsestuen, James Goodman, Patricia Stroup, James Krahn

Purpose stated in subcommittee report: to review the tools presently authorized and potentially available to the Secretary, which could provide “relief to dairy farmers in times of financial stress” that existed in 2009 and continues to persist in 2010.

A list of policy options was passed out to members of the committee with five columns:

- Tools
- Could this tool be used at the Secretary’s discretion in 2010?
- Which programs have legislative or WTO (treaty) boundaries?
- Which programs are constrained by budgetary limits?
- Which programs have regulatory limitations that inhibit the Secretary from responding rapidly?

In their discussions with USDA representatives, the committee found that there were no options that could be implemented easily, but the subcommittee report did suggest some recommendations:

- Enact and fund provisions in the 2008 Farm bill for electronic price reporting and auditing.
- Maximize exports under the Dairy Export Incentive Program (DEIP).
- Work with FDA to enforce standards of identity.

Mr. Bourbeau read a letter from Jackie Klippenstein from Dairy Farmers of America. According to the letter, one of the reasons that dairy prices have not recovered quickly is a high inventory of cheese. According to the letter, USDA has the authority to purchase an additional 75 million pounds of American-style cheese for feeding and nutrition programs. The letter states that Mr. Dwain Forester, DFA member and a dairy farmer from the State of Washington, has developed a milk voucher proposal for people accessing food banks. The program would operate in a manner similar to that of the Women, Infants and Children (WIC) program. Additionally, according to the letter, under Section 32 authority and Section 5 of the CCC Charter Act, USDA may buy cheese for feeding programs.

There was considerable discussion among DIAC members concerning justification for using DEIP funds when U.S. domestic prices for dairy products are currently less than world prices. Larry Salathe, of the USDA Chief Economist’s Office, stated that use of DEIP funds depends upon approval by the Office of Management and Budget (OMB). He said it is difficult to justify use of DEIP funds (taxpayer money) when U.S. domestic prices are less than world prices, since the U.S. is already competitive on the world market. He said that another justification for using the DEIP is to counter export subsidies provided by the European Union (EU). Currently, the EU is not providing export subsidies.

There was some discussion concerning a temporary increase in dairy product support prices and other means that may be available for setting floor prices for milk or dairy products. There was also some discussion about the Specter-Casey bill. Milton Madison, from USDA’s Farm Service Agency (FSA), stated that there would be no impact of raising dairy product support prices to the levels of the temporary increases in 2009 because current market prices for dairy products are considerably higher than those purchase prices. Dr. Madison stated that USDA does not currently have a mechanism to set a floor price for farm milk outside the DPPSP.

Chairman Novakovic clarified the difference between floor prices set through the Dairy Product Price Support Program (DPPSP) and minimum prices set by the FMMO system, as proposed under the Specter-Casey bill. Through the DPPSP, the government buys products from the market to establish floor prices. Through the FMMO system, the government sets minimum prices that processors must pay for milk associated with an FMMO. If the minimum prices were set at a relatively high level, it would spur production, begging the question of where the increased production would be sold. Dr. Novakovic also pointed out that, in contrast to administrative changes in the DPPSP allowed under the 2008 Farm Bill, changes to the FMMO take longer to implement due to the formal rulemaking process required.

Committee members further discussed the letter from Ms. Klippenstein. Dr. Salathe cautioned the committee that money for the programs mentioned in the letter has already been allocated. Also, according to Dr. Salathe, some information concerning authorities mentioned in the letter as available to USDA was inaccurate. Dr. Novakovic asked if information concerning the allocations of funds and authorities could be made available to the committee the next day.

Adjournment, 4:30 PM

Friday, June 4, 2010

Call to Order and Opening Comments, 8:30 AM

Solomon Whitfield called the meeting to order.

Chairman Novakovic mentioned that people are welcome to submit comments to the DIAC and that there are a number of options available for people to do so: a tool available on the Internet, an email address, or a handwritten letter can be sent to the committee.

Edward Maltby indicated that there has been some criticism from those who scrutinized the minutes of the April meeting that some issues were not covered sufficiently. He indicated that it would be good to “put on the record” that the minutes of the meetings are summaries, not transcripts.

The Impact of Globalization on the U.S. Dairy Industry,
Tom Suber, United States Dairy Export Council (USDEC), 8:40 AM

Tom Suber discussed information based upon a report from the consulting company, Bain and Co. (Bain report, study).

Mr. Suber explained that a USDEC task force established two objectives for the study: to provide a strategic analysis of the global dairy landscape and to determine if there are suitable programs to address the opportunities and challenges of globalization.

According to the Bain report, future world economic and population growth will be driven by emerging markets, whose population and per capita income are increasing, leading to increased global dairy demand. Traditional exporter's production growth rates are slowing, while emerging suppliers will take time to develop. The study found that traditional suppliers will not be able to meet growing import needs, creating a "latent demand gap." It concluded that supply/demand imbalances will drive continued volatility across commodities, including dairy.

Mr. Suber explained that customers view the U.S. as well positioned to succeed in global dairy trade for several reasons:

- "Low enough" costs
- Highest capacity to increase supply
- High quality products
- Diverse supply base
- Relatively low seasonality

However, he also highlighted some U.S. shortcomings:

- "In & out" of global trade
- Quality not on par with Oceania
- Product mix does not align with customer needs
- Inconsistent customer service
- Volatile pricing/limited contracts

According to the presentation, historical dairy policies and programs, such as FMMOs and DPPSP, have served important purposes. However, Mr. Suber was of the opinion that the combined impact over decades has weakened the U.S. global competitive position.

Mr. Suber explained the four strategic options outlined in the study for the U.S. dairy industry:

- Fortress USA: Complete focus on domestic market
- Status quo: Limited industry efforts to address globalization
- Consistent exporter: Commitment to global opportunities for U.S. milk supply
- Global dairy player: Consistent exporter strategy, plus the industry moves to an export focused model

Mr. Suber stated that USDEC recommends moving toward a consistent exporter strategy. According to Mr. Suber, USDEC currently has in place a Globalization Operating Committee examining the following issues: pricing reform; trade treaties; volatility management; quality, safety, traceability; standards and specifications; pre-competitive sales and marketing programs; and science and technology.

In discussion, the committee members offered that the Bain report did not take into account environmental concerns and resource scarcity. In response, Mr. Suber said that eventually environmental costs will be reflected in price as buyers will need to meet demand with higher cost supplies. However, he is of the opinion that environmental constraints are more severe in other countries and that the U.S. will be able to handle its environmental problems.

Another DIAC member asked how the consistent exporter strategy would impact market volatility. Mr. Suber explained that the system is already volatile, but it is aggravated by the fact that the U.S. is a last-in, first-out exporter. He is of the opinion that this surrenders the export market to other countries. In response to another question, Mr. Suber explained that the problem now with U.S. dairy production is that it does not produce to the specific standards demanded by global customers. Instead, U.S. processors produce products that can be sold to the government.

Further discussion focused on the growth and then collapse of the U.S. export market. Mr. Suber explained that export growth started in 2003, and in response many countries increased production to meet that demand. He said that exports began to decrease even before the high prices of 2007 and 2008, and then the credit crunch exasperated the problem.

A DIAC member commented that the same story of unmet global demand has been told for the past 30 years and wondered why the DIAC should take this report any more seriously than past reports of this type. Mr. Suber said that the dairy industry will go through a transformation like every other agricultural commodity has. He said that the beef and corn industries have already seen their markets go global and the same will eventually happen with dairy.

Presentations by Andrew Novakovic, Cornell University

Price Volatility in U.S. Dairy Markets, 9:30 AM

Presentation prepared by Andrew Novakovic, Charles Nicholson, and Mark Stephenson.

Dr. Novakovic discussed three characteristics of price: (1) uncertainty/certainty, (2) instability/stability; and (3) inadequacy/adequacy. He pointed out that these price characteristics are largely independent (one does not imply the other) and that one must be careful and clear in understanding which is the fundamental problem.

Dr. Novakovic illustrated that the choice of statistics used to measure volatility are important. Statistical measures such as the inter-quartile range, variance, standard deviation and coefficient of variation measure magnitudes of price changes. Measures such as counting how many times the price rises over a period of months and the Black-Scholes, or log relative method (a more complex formula used in finance and engineering to measure volatility) measure the frequency of price changes. Using the latter methods, the analysis he presented indicates that volatility is highest in the middle of the marketing chain and that it is somewhat muted or altered at the farm and retail levels.

According to the analysis, corn prices and prices of steers and heifers have become less volatile in recent years, while milk prices have become more volatile. By these measures milk prices are more volatile than beef prices and comparably volatile to corn prices. There are some issues in comparing volatility of corn prices with milk prices. The price that a dairy farmer receives in a particular month applies to the production of the month. The same is not necessarily the case for a farmer selling corn.

A spectral analysis indicates that there have been several cycles in dairy prices from 1988-2007:

- Triennial, 36-month cycle - large and exploding
- Biennial, 26-month cycle - quite large and possibly growing
- Annual, 12-month cycle - smaller, erratic
- 9-month cycle - small and stable

Spectral analyses of several dairy prices, milk production and stocks show similar three-month patterns. The timing suggests a relationship to the reproduction of dairy cattle, but a causal link has not been formally established. Dr. Novakovic said that more work needs to be done to understand the relationships among the variables and more information about the cycles so they are easier to predict and react to.

Farm Savings Accounts (FSAs) as a Tool for Dairy Farm Risk Management, 10:00 AM

Presentation prepared by Brent Gloy and Andrew Novakovic

Dr. Novakovic said that a person's reaction to a policy solution depends on one's perspective about the nature of the problem. If one believes that the market is not broken, but that the market provides outcomes that are difficult for farmers to deal with at times, FSAs may be viewed as a possible solution.

According to Dr. Novakovic, FSAs could potentially allow income smoothing by creating incentives to save when returns are high and withdraw savings when returns are low. One incentive would be to defer taxes on earnings that are put into special FSAs. Savings could have the additional incentive of a matching payment feature provided by the U.S. government. Dr. Novakovic believes that eligibility for such a program should be very broad and should have no qualifications as to when funds could be deposited or withdrawn.

Cornell University has collected data from about 300 New York dairy farms during the period from 1993-2009. The analysis presented examines cash flow characteristics of farms. The data indicate that there have been dramatic differences in costs of production among the farms, as well as in gross and net returns. The data further indicate that dairy farmers largely manage cash flow by investing in boom years and borrowing in bust years. Farmers do not generally carry large cash reserves, so incentives would be needed to change this behavior, such as tax deferrals and matching contributions made by the government.

Mr. Novakovic said that the use of credit markets to balance booms and busts in operating cash flows comes at a cost. It can lead to overinvestment in flush years and expensive debt in lean years. This is in sharp contrast to using reserves to balance cash flows. One reason for using debt and investment is that these transactions help to reduce tax liabilities. Inasmuch as farmers seem to be especially averse to paying income taxes, any alternative to current cash management practices would have to address tax management concerns. This also means that the tax collection implications for the government are likely to be minimal because dairy farmers generally arrange to minimize their tax liabilities.

The presentation listed key differences between government-run farm savings accounts and government subsidies:

- Farmers have personal responsibility and manage savings and withdrawals to suit their needs with FSAs.
- Government programs have national, state, or county triggers to determine payouts.
- With FSAs, farmers primarily manage their own money.
- Government subsidies primarily transfer other people's money to farmers.

Kathleen Merrigan, Deputy Secretary of Agriculture, 10:30-10:35 AM

(A brief break was provided from the FSA presentation by Dr. Novakovic to provide an opportunity for Deputy Secretary Merrigan to address the committee.)

Deputy Secretary Kathleen Merrigan encouraged those in attendance to visit the USDA Farmer's Market. She mentioned that she had attended the National Rural Summit in Missouri the day before and that there had been considerable discussion about the dairy industry. She offered a word of encouragement to committee members and acknowledged that the work they are doing is important.

Discussion continued, 10:35 AM

One DIAC member noted that the average cost of production for the New York farms studied by Cornell was around $17 per cwt, but the average price received was $15 per cwt. They asked that, if farmers are always $2 short, how could they put money away in FSAs? Dr. Novakovic explained these total economic cost figures accounted for factors such as equity and personal labor.

One member noted that the cost of production data used by Cornell included economic costs. They believed it would be more appropriate to look at income per cow instead of net revenue, which has imputed costs.

Another member asked if there is more volatility down the supply chain in "up" markets rather than "down" markets. Dr. Novakovic stated that the upside adjustments are slower and smaller than on the downside, but there is a response in wholesale and retail markets.

Break, 10:45 AM

Subcommittee C Report and Discussion, Milk Price Volatility, Chairman Jay Bryant, 11:10 AM

Subcommittee Members: Jay Bryant, Timothy den Dulk, Debra Erb, Robert Schupper, Sue Taylor

Jay Bryant reviewed several main points that the subcommittee discussed:

- Volatility will be an ongoing factor in dairy markets.
- Volatility significantly affects all levels of the supply/demand chain.
- There is a need to learn from practices and solutions used for other volatile commodities.
- There is a need to understand aspects of existing policies that are affecting volatility and the costs and benefits of adjusting policies.
- What market-based or government solutions exist or can be developed?

Members of the subcommittee elaborated on the points summarized by Mr. Bryant. A wide variety of topics and proposals were discussed among the committee members including:

- the idea of a risk management margin line of credit to be administered by the Farm Service Agency (FSA);
- tax deferments for dairy producers;
- developing solutions that benefit the industry as a whole rather than particular segments;
- the use of government policy tools to manage market volatility versus tools to help individuals manage risk;
- demand-side proposals;
- whether or not , and the extent to which, DPPSP and MILC increase or decrease volatility;
- developing solutions that allow better market responses to price signals through policies that facilitate relationships among buyers and sellers;
- examining government regulation of other commodities to consider changes to dairy policy.

Sue Taylor elaborated on the government administered margin line of credit. Ms. Taylor said that the idea is based on the premise that margin calls are a deterrent to using traditional futures. Typically, the cooperative covers the cost of the margin calls, but they can only finance a limited amount. A government-run line of credit for cooperatives to cover these margin calls would allow more producers to use the futures market.

Tim den Dulk commented on the farm savings account concept, adding that the government could allow farmers to defer taxes, assuming they did not expand production. By doing this, farmers could put more equity into their operations instead of expanding their herd.

Bob Wills asked the subcommittee to look into whether the MILC program insulates small farmers from the impacts of low prices and contributes to the duration of low milk prices and/or affects volatility. Jay Bryant agreed that programs that create artificial circumstances prevent the fast transmission of market signals to farmers. Sue Taylor added that the DIAC should not try to find a solution that insulates producers that does not also provide risk management solutions on the demand side. She added the DIAC should consider an industry-wide solution, not risk management solutions for individuals in the chain.

Bob Wills also drew from the presentation on volatility and concluded that if most volatility is predictable, then maybe the DIAC should look at what can be done to dampen the cyclical volatility.

Ed Welch said that he does not think the price support or MILC programs contribute to volatility. He said that, in the 1980s, the support program lessened volatility and only 30 percent of the milk production received MILC payments. Dr. Novakovic stated that there is a difference between decreasing volatility and prolonging the problem. Paul Bourbeau added that he did not know if the MILC program is prolonging the problem, if that was such a bad thing if it does. His concern is if dairy producers overcorrect when there is a lack of demand, what happens when demand comes back and there is no supply?

Dr. Novakovic stated that the committee needs to determine what level of volatility is acceptable. He noted that many marketers believe some volatility is necessary to create marketing opportunities. He added that when people talk about adjustments in or solutions to a volatile market, the discussion seems to always focus on producers. Perhaps we could do something equally creative on the demand side.

Patty Stroup said that, in her ideal world as a buyer, she would like individual relationships with suppliers so that specific demand needs can be easily communicated. Mr. Welch said that nothing precludes buyers now from forming such an arrangement – it is always just about price. Ms. Stroup stated that now she buys milk at classified prices and is unable to use long-term contracts. Mr. Krahn stated that many producers did not like this type of “ideal world” when it existed in the past. Ms. Stroup agreed that there were contract disputes, and maybe the DIAC could look at marketing agreements and the Perishable Agricultural Commodities Act.

Dr. Novakovic urged the committee to think about how to distill the information discussed into a committee report. He asked the committee to think about what a solution would look like. What is an acceptable range of volatility? He also asked the committee to think about solutions on both the supply side and demand side.

Lunch, 12:00 noon

Authority Granted to USDA Under Current Legislation,
Larry Salathe, Staff Economist, USDA, Office of the Chief Economist, 1:10 PM

Larry Salathe prepared a chart that was passed out to committee members titled *Authority Granted to USDA Under Current Legislation*. This was in response to discussion of Subcommittee A's presentation the previous day.

According to Dr. Salathe, current authority exists for all of the options discussed by Subcommittee A except for a milk voucher program for food kitchen patrons, which would need new Congressional appropriation. OMB approval would be needed for full utilization of the DEIP, increasing dairy product support prices, buying additional dairy products under Section 5 authority of the CCC Charter Act, and buying dairy products using Section 32 authority. Existing discretion could be used for buying additional dairy products for distribution through domestic nutrition programs or distribution for international food aid programs. Dr. Salathe explained that the available funding has already been allocated for the programs by commodity and that any additional funding for dairy products would have to be justified. Additional purchases of dairy products would most likely need to come from reductions in expenditures for other commodities; this could be in conflict with other USDA goals, such as providing assistance to producers of commodities who do not have support programs or providing a mix of commodities to schools and other institutions that best meets their needs.

Discussion of FMMO procedures, Dana Coale, USDA AMS Dairy Programs, 1:15 PM

Before discussing FMMO issues, Dana Coale responded to a question from Robert Wills' from the previous day concerning costs to the industry for mandatory price reporting. According to an economic analysis, costs were estimated as $381.26 per plant per year for a total of $37,363.48 per year.

Dana Coale also discussed the supplemental rules of practice for FMMOs that were implemented as a result of the 2008 Farm Bill. From the point at which USDA goes to a hearing concerning a proposal to change FMMOs to the time of implementation takes about 12 months. Ms. Coale briefly discussed requirements for proposals, the hearing process, and the implementation process. Ms. Coale emphasized that FMMO decisions are based upon hearing record evidence. Specific information concerning requirements for proposals and the supplemental rules of practice are provided on the USDA AMS Dairy Program's website.

Robert Wills asked for an estimate of government costs and industry compliance costs for administration of FMMOs. Ms. Coale responded that AMS Dairy Programs has estimated costs for the industry to submit forms needed for the FMMO program and that she would provide the information to the committee.

Subcommittee B Report and Discussion, Dairy Farm Profitability,
Erick Coolidge, Chairman, 1:30 PM

Subcommittee members: Erick Coolidge, Ray Souza, James Williams, Edward Welch, Edward Maltby, Robert Wills

Erick Coolidge reviewed several issues that the subcommittee had discussed. The subcommittee felt that agricultural lenders have been dealing with the uncertainty of the industry on a national level. A question to be considered is whether or not regional differences should be considered. There are several reasons why one size does not fit all. Mr. Coolidge discussed the various costs that need to be considered in recommendations for dairy farmer profitability. He discussed the impact of agriculture on the overall economy. Mr. Coolidge explained that the subcommittee had differences of opinion concerning the effectiveness of the CWT program. There was basic agreement among the subcommittee members that the Milk Income Loss Contract (MILC) program has been a help for farms with fewer than 150 cows, but there was disagreement concerning farms of larger size. Areas for consideration in addressing profitability issues include FMMOs, import and export markets, promotion of new and growing markets, credit policies, energy policies, environmental concerns, and ways to improve cheese markets. In considering changing policies concerning new product support or promotion, the committee should consider the possibility of putting a transition plan to accommodate adjustment.

Ray Souza discussed enhanced nutritional standards for fluid milk. He stated that there are programs in different areas of the country for enhanced fluid milk standards. According to Mr. Souza, there are some misunderstandings about these programs. It is his understanding that the Food and Agricultural Policy Research Institute (FAPRI) will release a study about enhanced fluid milk programs in one or two weeks. The subcommittee is planning to discuss the report after it is released. The subcommittee will also look at the implications of eliminating the DPPSP and possible transition policies associated with its elimination.

Robert Wills discussed the feasibility of lowering somatic cell count standards in the U.S. from 750,000 to 400,000. According to Mr. Wills, this would help to open up export markets, improve the quality of dairy products, and reduce the size of the U.S. dairy herd. Edward Welch stated that government policies concerning energy, ethanol, and immigration should also be concerns for the committee to address.

Questions arose concerning the procedure by which somatic cell count standards can be changed. Will Francis, Associate Deputy Administrator for Order Formulation and Enforcement, USDA AMS Dairy Programs, was called upon to inform the committee. According to Mr. Francis, in each odd-number year there is a National Conference on Interstate Milk Shipments. These meetings are primarily oriented towards helping to coordinate state regulations and operate with guidance and assistance from FDA. The Conference is meeting next April in Baltimore. Proposals will probably be required to be submitted by December 2010. If a proposal from the meeting passes, the Food and Drug Administration (FDA) will examine the proposal and will either concur or not concur with the proposal around October of that year. From that point, if FDA concurred it would be about a year until the proposal would be implemented. Effectively, a concept proposed this year and accepted in 2011 would not be implemented until around October

2012. Mr. Francis further explained that the model document that the conference works with is the Pasteurized Milk Ordinance. This model document itself has no regulatory authority, but it is adopted by States for regulating milk sanitary standards. Jim Krahn said that the state of Oregon is in the process of reducing their somatic cell count standard. He believes that other states should do this if a national organization will not.

Paul Bourbeau asked if the committee put much importance on credit policies. Mr. Souza said that extending credit is good as long as it is accompanied by fundamental change in the system. He said that extending credit does not do much good if it just prolongs the agony.

Ed Maltby said that profitability is a social and economic issue. He said that policies should reflect what people want: either vibrant rural communities or cheap milk.

Break, 2:15 PM

Committee Work Session, 2:30 PM

Chairman Novakovic stated that the next meeting of the DIAC will be September 23-24, 2010, in Washington, DC. At that meeting, he would like for the committee to review a first draft of a report that draws mainly from the work of Subcommittee A. In addition, he plans to discuss an outline of the final report that is due to be released in March 2011. Dr. Novakovic proposed that each subcommittee appoint a person to work with him to assist in drafting the outline. In providing a framework for the work session, Dr. Novakovic asked the committee to consider items for which the committee needs more information and reactions to proposals and ideas that they have heard.

Paul Bourbeau read a letter from the Vermont Farm Service Agency State Committee asking for emergency assistance for dairy farmers.

There was some discussion as to whether or not Subcommittee A will be able to produce anything substantial since it did not appear that the potential policy proposals they had considered could be implemented quickly. Dr. Novakovic stated that even though there are limitations in implementing proposals quickly, the subcommittee could still consider proposals that could be implemented under existing authority and comment on ways that existing laws and regulations could be made more responsive.

There was some discussion among committee members that events in the weeks to come will likely shape their discussions. These include developments concerning a bill by Representative Costa, pending legislation by Senator Sanders, proposals by the National Milk Producers

Federation, hearings by USDA and the Department of Justice, results of the CWT herd retirement, and analyses by Mark Stephenson and Charles Nicholson.

There was discussion concerning analyses that the committee could request. Jerry Cessna, Senior Agricultural Economist for USDA AMS Dairy Programs, was called upon to discuss analysis that could be provided by AMS Dairy Programs. Mr. Cessna discussed a comprehensive econometric model of the U.S. dairy industry that AMS could use to examine certain proposals. The model has been used mainly to analyze the FMMO system, but it can be used for other purposes. The feasibility of using the model to evaluate any specific proposal would depend upon the proposal. If it is possible to analyze a proposal using the model, the length of time for analyzing the proposal would depend upon the proposal and the assumptions used. The committee was interested in other models that may be available to help the committee to evaluate proposals. Dr. Novakovic stated that he could put together a list of dairy models used around the country.

Committee members indicated that they might request that a panel of economists be on the agenda at the September meeting to get their reactions to various proposals.

James Krahn asked that the committee focus on the issue of increasing solids standards for fluid milk and lowering somatic cell count standards. Dr. Novakovic asked Mr. Bourbeau to add this to the list of items to be considered by Subcommittee A.

Mr. Bourbeau asked Dr. Novakovic for clarification concerning the timeline for the report to be drafted by Subcommittee A. Dr. Novakovic indicated that he would want a well-written draft to be available for the September meeting. The committee as a whole will work with the draft to reach a point where there is endorsement for a report that can be issued to the Secretary shortly after the September meeting.

Dana Coale emphasized to the committee that in requesting an analysis of a particular proposal it is very important that assumptions be well specified. She also pointed out that enlisting help from outside sources to analyze proposals would involve a cost. Ms. Coale mentioned that a study prepared by AMS concerning an increase in the solids standards for fluid milk has been provided to the committee. She indicated that requests for information to be presented concerning a particular subject at the September meeting need to be submitted to USDA by July 15.

Mr. Krahn asked Dr. Novakovic how the committee should go about responding to proposals made by groups outside of the committee. Dr. Novakovic stated that he is not in a position to prejudge how the committee will respond to those proposals. He does not believe that the committee will be in a position to provide up-or-down votes on certain proposals by the

September meeting or finalize plans, but that the committee will be proceeding in that direction. Ms. Coale stated that as information is made available concerning various plans, USDA will make that information available to the Committee.

Mr. Bourbeau asked the committee to examine a law that allows sheep ranchers to hire immigrant labor under a special permit to determine if dairy labor could fall under the same category. Ms. Coale stated that USDA would try to gather some information about the subject that could be disbursed to the committee.

Adjournment, 3:30 PM