Minutes of the Dairy Industry Advisory Committee
Thursday, September 23, 2010, through Friday, September 24, 2010

A third public meeting of the Dairy Industry Advisory Committee (DIAC) was held at the USDA Headquarters, Washington DC, on Thursday, September 23, 2010, through Friday, September 24, 2010.

Committee members present included the following:

Name	State	Business
Andrew Novakovic, Chairman	NY	Cornell University
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
Randy Romanski	WI	Wisconsin Department of Agriculture, Trade and Consumer Protection
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.
James (Ricky) Williams	GA	Williams Dairy Trucking, Inc.
Robert Wills	WI	Cedar Grove Cheese Inc.

Vice Chairman Erick Coolidge, of Le-Ma-Ra Farm, Pennsylvania, was unable to attend. Paul Bourbeau was unable to attend on Thursday, September 23, but was able to attend on Friday, September 24.

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, September 23, 2010

Call to Order and Opening Remarks, 8:30 AM

Solomon Whitfield, Designated Federal Official, called the meeting to order.

Chairman Andrew Novakovic asked those in attendance to observe one minute of silence due to the untimely death of committee member Rod Nilsestuen, stating that Mr. Nilsestuen's death is a great loss to the State of Wisconsin and to the Dairy Industry Advisory Committee. He introduced Randy Romanski as a new member of the committee, serving in place of Mr. Nilsestuen. Mr. Romanski serves as Wisconsin Secretary of the Department of Agriculture, Trade and Consumer Protection, the position formerly held by Mr. Nilsestuen.

Analysis of Various Proposals: Panel and Committee Discussion, 8:40 AM

Mark Stephenson, University of Wisconsin
Chuck Nicholson, California Polytechnic State University at San Luis Obispo
Scott Brown, Food and Agricultural Policy Institute (FAPRI), University of Missouri
Wayne Knoblauch, Cornell University

Dr. Novakovic introduced members of the panel and asked them to comment on problems concerning dairy farmer profitability and volatility from each of their perspectives.

Opening remarks of panel:

Dr. Knoblauch described 2008 as an outstanding year followed by 2009 as a devastating year for many dairy farmers. He stated that he directs a program called FarmNet which provides an 800 number for dairy farmers to call for financial or personal assistance. Calls from distressed dairy farmers have been at an all-time high, and he believes that farmers are experiencing record cash flow problems. He stated that some degree of price variability is good, but the level experienced recently is harmful.

Dr. Brown emphasized that it is important to examine what caused problems for dairy farmers, citing high feed costs, other costs related to dairy farming, and the recession. International demand has increasingly been an important factor that has influenced the dairy industry. He does not think that this level of variability will become the norm in the future.

Dr. Stephenson stated that 2009 was most unusual. He pointed out that in recent years cycles in milk prices have become more predominant, with higher highs and lower lows. In 2009, the cyclical pattern pointed to lower prices, but actual prices were lower than expected.

Dr. Nicholson stated that he thinks of the problem with profitability and volatility in two senses: (1) the effects of volatility on real costs throughout the supply chain, and (2) profitability issues at the farm level at the downturns of cycles. He mentioned that in an informal survey of a diverse group of people from the dairy industry, 91 percent stated that volatility was a greater issue than it was five years ago and 71 percent stated that it is causing a problem for their business planning.

Dr. Novakovic mentioned a study by Dr. Brown, done at the request of National Milk Producers Federation (NMPF), concerning NMPFs Foundation for the Future (FFTF) proposal and a study by Drs. Stephenson and Nicholson (Nicholson and Stephenson Study), done at the request of a group of organizations that support a bill often referred to as the Costa-Sanders plan. Both studies were made available to the committee. Dr. Novakovic stated that the committee could direct questions to the panel concerning these studies or other concerns. The following paragraphs summarize answers to questions from the committee.

In response to a question concerning long-run profitability of dairy farmers, Dr. Nicholson stated that he believes that costs all along the supply chain are probably higher in the long run due to the extreme level of price volatility experienced in recent years. Dr. Stephenson noted that many dairy farmers have gone out of business over time but that it is difficult to determine whether this is due to a profitability problem or an issue of economies of scale. He noted that according to 2009 USDA data, 745 farms produce 30 percent of the milk supply. Dr. Stephenson is questioned profitability is a problem across all farms or one that differentiates declining farms from growing farms.

Dr. Brown stated that FAPRI is fairly optimistic concerning the long-run profitability of the dairy industry with an increase in global demand over time. Dr. Knoblauch emphasized the difficulty that farmers have with cash flow positions over time given a large degree of price volatility. Dr. Knoblauch pointed to the analysis of annualized income less feed costs in the study by Drs. Stephenson and Nicholson, stating that the analysis can be taken further to look at the effects of these margins on cash flow for operations of different herd sizes. He illustrated the conditions in 2009 and the contrast across farms using data for the Cornell Dairy Farm Business Summary, an annual extension project that collects and reports extensive data that describe about 200 cooperating farms in New York.

Concerning whether the focus of dairy policies should be national or regional, Dr. Stephenson pointed out that some areas of the country are more conducive to dairy farming than others. Dr. Nicholson stated that he believes that the dairy industry is becoming more national, or international, in scope. Therefore, he said a national policy would be appropriate. Dr. Brown said that volatility can be fixed now with the current tools. However, he said there could be many unintended consequences. Dr. Knoblauch stated that regions are not homogeneous and that needs are based upon different parameters, but there should not be regional policies.

In response to a question concerning proposals and policies to reduce volatility, Dr. Brown emphasized that such tools may have unintended consequences. Dr. Nicholson stated that the three programs examined in their study were all effective at reducing volatility according to their analysis. At the request of the Chairman, he also did a preliminary analysis of a voluntary farm savings account policy and found that this too would reduce price volatility. Dr. Stephenson pointed out that most of the proposals being discussed focus on the supply side, but there are possibilities of reducing volatility through demand-side policies. Dr. Brown stated that the "hardness" of the floor needs to be considered in selecting a policy tool, citing the Milk Income Loss Contract (MILC) program as a program with a relatively soft floor and the proposed FFTF as a program with a relatively hard floor. This is to say, that both programs could be described as having the effect of supporting prices to farmers, but the degree of support provided by the MILC is less precise and varies considerably across farm sizes.

In response to a question concerning the causes of price volatility, Dr. Nicholson stated that much of the price variation seen in the dairy industry is not unique to the dairy industry. He pointed out cycles that have been observed in the industry, stating that while entities in the supply chain act rationally, he believes their uncoordinated actions result in increased volatility. Dr. Brown mentioned general economic activity, feed costs, and fuel costs as factors that have contributed to greater volatility, at least in the last couple of years. He also believes that supply may have become less responsive to changes in price, exacerbating volatility. Dr. Knoblauch stated that he believes that the milk price has contributed much more to variability in farmer income than changes in costs of production.

The panel was asked to compare government intervention and risk management in the dairy industry to other industries. Dr. Stephenson pointed out that dairy is different from many other agriculture industries in that farm milk cannot be stored. This makes risk management more difficult for dairy farmers. He also said that individual dairy farmers typically do not see how their individual actions affect price. Dr. Nicholson pointed out that agriculture, in general, has high fixed costs and relatively inelastic supply and demand that contribute to volatility. He made the point that the use of product diversification as a tool to lower risk is more difficult in dairy than for other agricultural commodities, using fruits and vegetables as an example. Dr. Brown pointed out that other agricultural commodities have used supply management tools and stated that peanuts and tobacco have moved away from supply management. He indicated that, while there are some differences for dairy in comparison to other industries, he does not think that dairy is so different that dairy producers cannot also use risk management tools. For example, hog producers would argue that they cannot delay their marketing strategy for more than a few days since most of them do not have the ability to slaughter the hogs and store the pork themselves. Dr. Knoblauch made the point that when corn prices reach $5, a hog producer can choose to sell all of the hogs; dairy producers do not have the same flexibility because they have large capital investments.

Concerning the effects of price volatility on reformulation of products, Dr. Nicholson stated that we do not really have a handle on the relationship between volatility and product formulation. Dr. Brown stated that when food processors reformulate products to use non-dairy based ingredients when dairy prices are high, it is not certain that they will "never come back to using dairy ingredients in their products," but they may be slow to come back to the dairy market.

There was discussion concerning the relatively low level of volatility in retail prices compared to farm-price volatility. Dr. Stephenson stated that the retail part of the supply chain buffers swings derived from prices at other levels. He stated that temporary spikes in prices at the farm level may not be passed on to consumers but long-term changes are passed on. Dr. Brown pointed out that there are many costs besides the costs of milk in the transmission of farm milk prices to prices for milk and dairy products at retail. Dr. Nicholson mentioned that several New York studies indicated strong correlations between retail and farm-level prices.

The panel was asked to comment upon the adequacy of proposals to reduce volatility. Dr. Nicholson stated that while the proposed programs may reduce volatility, they do not remove all volatility. Dr. Stephenson indicated that their study indicates that variability would be significantly decreased with the proposed programs that they evaluated. Dr. Brown was of the opinion that a lot of volatility from the last 2-3 years was due to factors external to the industry. He also stated that it takes "a big stick" to significantly reduce variability. He added that government budget constraints will be considered as proposals are evaluated.

Concerning expectations for future volatility in the dairy industry, Dr. Brown stated there is uncertainty regarding the potential for greater or lesser volatility in the future. Dr. Nicholson stated that he believes there will be relatively little smoothing expected in volatility given current programs in place.

When asked about the effect of supply management on cow values**,** Dr. Stephenson stated that cow values in the future could depend, to a significant extent, on export demand. Dr. Nicholson stated that their study did not analyze the effects of the proposed programs on cow values but this analysis could be done.

The panel was asked to comment upon the loss of equity by dairy farmers. Dr. Stephenson indicated that there was a large amount of equity lost in the dairy industry in 2009. However, he believes equity could be restored if there are substantial export opportunities for the industry that would drive milk prices up again. He does not believe credit markets would shy away from lending based upon the recent downturn. Dr. Knoblauch sees a greater problem with liquidity for the dairy industry in comparison to equity. He indicated that his data indicate that producers with large herds lost a greater percentage of equity than smaller farms in 2009 because of the MILC payments received by smaller farmers.

The panel was asked to comment upon the experiences of supply management in other agricultural industries. Dr. Brown stated that other industries have moved away from supply management because they perceived better ways to address industry issues. He said that "base" values rise due to supply management policies. In tobacco, payments are now being made to farmers for quota values that developed over time. While the dairy proposals attempt to limit "base" values that rise due to supply management, he found it difficult to think that there will not be some value associated with the proposals. Dr. Brown added that once an industry starts down the road of supply management, changing the policy can become difficult. Dr. Nicholson mentioned that marketing orders, for products other than dairy, allow for supply control but that those industries have largely moved away from using these options because it restricts people in their natural business dealings.

Concerning long-run effects of proposed policies on milk prices, Dr. Stephenson stated that the proposals focus on margin rather than price because they recognize that there is volatility in inputs as well as price. Dr. Nicholson stated that according to their study, FFTF would marginally increase average milk prices over time while the Costa-Sanders proposal would slightly lower prices over time. Dr. Brown stated that according to his analysis, FFTF would slightly lower prices but that profits would be slightly increased.

The panelists were asked to describe modeling constraints and also how trade is accounted for in their analysis. Dr. Brown said that the FAPRI model analyzes how programs would operate under different market scenarios, including shocks to the export market. Dr. Nicholson began by noting that models are best utilized when taken together and compared rather than contrasted. He said that they aligned their assumptions about the underlying baseline for factors not predicted within the model, such as feed prices, with FAPRI's assumptions so that differences in output would not be a result of different assumptions about exogenous effects. He added that he does not think that a different base year (with different trade levels) would significantly affect the comparative results across policies. Dr. Stephenson stated that their study accounted for trade effects by looking at the effect of hard shocks to exports similar to what occurred from

2006 to 2009. He said the model has explicit import level details such as tariff rate quotas and opportunities for use of imported dairy products.

Concerning the use of risk management tools by farmers, Dr. Knoblauch stated that the margin insurance proposal in FFTF is an extremely low safety net and that, from his experience, he does not believe that many farmers will opt to pay for additional insurance that would be available to them through the program. Dr. Stephenson stated that participation in risk management programs may be low because, while people do not like volatility, many of their businesses may not actually be threatened by volatility. Dr. Brown stated that in considering risk management tools, farmers look at the costs of participating.

Livestock Gross Margin for Dairy Cattle Insurance Plan (LGM-Dairy),
Joe Glauber, USDA Chief Economist, 11:40 AM

Dr. Glauber was invited to talk briefly about changes to LGM-Dairy, stating that the Board of Directors for the Federal Crop Insurance Corporation approved a subsidy for LGM-Dairy about two months ago. The subsidy level depends upon the level of deductible chosen. Also, instead of the premium payment being due up front, it is due at time of product delivery to the buyer. To obtain these benefits, a producer must contract with LGM-Dairy for several months. He believes that these changes will go into effect later this fall and perhaps participation will improve as a result. The structure of the margin calculation was also changed in a way derived from the FFTF proposal.

Public Comment Period
Mark Perosio, New York State Dairy Farmer, 11:45 AM

Mr. Perosio provided a paper to the committee entitled “The Strategic Dairy Reserve, Position Paper on the Dairy Industry.” The paper presents his proposals and solutions for the short-, mid- and long-term.

Mr. Perosio points to very low prices in 2009 as causing substantial problems for dairy farmers in the short term. He proposes a 350,000 – 400,000 cow herd buyout through the NMPF Cooperatives Working Together (CWT) program as a short-term solution.

Mr. Perosio stated that tuberculosis and Johnes disease are problems that need to be addressed in the medium term. He proposes testing and removing all diseased mature dairy cattle from the national milking herd over a four-year period. He added that farmers should be paid the current market value for their infected cattle. In the longer term, he believes that the Federal Milk Marketing Order program and milk pricing systems need to be reformed. He advocated that

USDA engage in a program to remove manufactured products from dairy markets when milk prices decline, using the CME spot market as the vehicle for the acquisition of product.

Mr. Perosio was of the opinion that 2011 will be worse for dairy farmers than 2009.

Lunch 12:00 noon

Panel and Committee Discussion, 1:00 PM

> **Peter Vitaliano, National Milk Producers Federation (NMPF)**
> **Robert Yonkers, International Dairy Foods Association (IDFA)**
> **Mike Brown, Glanbia Foods**
> **Bill Schiek, Dairy Institute of California**
> **Erica Pagel, Foremost Farms USA**

Dr. Novakovic introduced the members of the panel and asked them to comment concerning dairy farm profitability and milk price volatility.

Opening remarks of panel:

Dr. Schiek stated that 2009 was an extreme year, but we cannot say that the extremes cannot happen again. He believes that much of the volatility is related to greater exposure to global shocks as the U.S. dairy industry has become more of a player in global dairy markets.

Mr. Brown stated that there have been some structural changes in the U.S. dairy industry. Dairy farms that purchase inputs may have lost some competitive advantage as feed prices rose with increases in ethanol production. He pointed out that the U.S. is not as insulated from world markets as before because of trade liberalization.

Dr. Yonkers pointed out that while dairy farmers have suffered from volatility, the same can be said of many other agricultural inputs (i.e. trucking and packaging). He stated that there are problems with supply chain management in the dairy industry and he believes current policies are contributing to these problems. He stated that there are problems with price discovery, pointing out that price discovery occurs at the wholesale level in the dairy industry, while price discovery occurs at the farm level for other agricultural commodities. He said that he disagrees with earlier comments that players in the dairy markets are not likely to use risk management tools given experiences of the dairy industry in the last 5 years.

Dr. Vitaliano emphasized that a greater understanding is needed of the structure and dynamics of demand. In the last 12 months, according to his estimates, 11 percent of total milk solids were exported. He estimates that the export market for total milk solids will generate twice the volume of demand growth as the domestic market. He stated that the problem with the downturn in 2009 was not that global export demand collapsed but that U.S. exports collapsed. In 2009, world prices fell and the volume of global dairy trade grew. In addition, in 2007, 15 percent of international milk trade was from the U.S., while in 2009, only 11 percent of milk traded was from the U.S. According to Dr. Vitaliano, FFTF provides a safety net while at the same time considering export realities. The Margin Insurance Program would help provide some level of margin protection to producers when prices are low rather than make adjustments on the supply side.

Ms. Pagel stated that steps need to be taken to make sure that the situation that occurred in 2009 does not happen again. Although Foremost has historically been opposed to supply management, they are willing to consider recent supply management programs that have been proposed and they are supportive of FFTF.

Summary of answers to questions by committee:

Dr. Novakovic invited members of the committee to ask questions of the panel. The following paragraphs summarize answers to questions from the committee.

Committee members responded to a question concerning the Federal milk marketing order program. Mr. Brown stated that Glanbia operates in a region that is not regulated by marketing orders and that they prefer this situation. He was of the opinion that Federal orders are difficult to operate in areas such as Idaho that does not have significant Class I utilization. Mr. Brown said that Glanbia is a cheese manufacturer and they pay their producers based on a cheese price formula.

Dr. Schiek believes that end-product pricing in marketing orders results in allocation problems and at times results in milk surpluses. He believes that the industry would be fine without an order system or with two classes of milk. Dr. Vitaliano stated that NMPF supports Federal marketing orders but recommends that changes be made. FFTF proposes that minimum pay prices for milk used for manufacturing purposes be replaced by competitive pay prices. He described the proposal as incomplete due to the complexity of making such changes and difficulty in getting agreement among their members.

Dr. Yonkers referred to FAPRI studies that have indicated that marketing orders have very little impact on the dairy industry. He would like to see FAPRI update their studies to show the impact of removing marketing orders with greater emphasis on international dimensions of the dairy industry. He mentioned other countries that he believes have been successful in eliminating price regulation in the dairy industry. Ms. Pagel stated that, given Foremost’s diversified production and the low Class I utilization in the Upper Midwest, Foremost would welcome the elimination of Federal orders.

Concerning the ability of milk processors to reallocate milk use based upon price signals, Ms. Pagel stated that Foremost has the ability to move milk from one use to another, but that there are constraints on such movements in the short term due to long-term contracts for finished products. Dr. Yonkers responded that contracts would be different without the Federal order system, stating that in his view, marketing orders are contributing to a lack of supply chain coordination and price discovery. Dr. Schiek stated that in the West, there are large single-product plants. Under a different type of system, large operators would have a larger portfolio of products and would build in greater flexibility in their marketing plans.

Concerning proposed supply management programs and risk management, Dr. Yonkers responded that both dairy processors and dairy producers would agree that reducing volatility would be beneficial, but he does not believe that the proposed programs are without adverse consequences. Mr. Brown stated that he admires NMPF for trying to keep FFTF "clean" from politicization, but he is concerned about the possibility that it will constrain expansion of farms. He mentioned that the policy group for Idaho Dairy Association is not recommending supply management. Dr. Schiek stated that to take a substantial amount of volatility out of the market will take "a big stick," and that risk management will be needed even if the Costa-Sanders bill becomes law. Dr. Vitaliano used the Canadian system as an example of a supply-management system that has had some negative consequences, benefiting farmers who initially had substantial production but not benefiting newer farmers. He stated that by contrast, when margins get very low, FFTF has a "sledge hammer" that would come into play, but it would not last very long. He stated that NMPF strived to avoid market distortions with their proposals.

Concerning risk management, Mr. Brown discussed some creative programs that Glanbia has established for hedging risks. He believes more can be done to help processors and producers manage risk, but that it will take time. Dr. Yonkers stated that after the losses suffered in 2009, more people may be likely to hedge prices when approaching another downturn. Ms. Pagel stated that Foremost has a program for hedging but that their producers do not use it to a great extent.

In response to a question concerning the reasonable range of volatility, Dr. Vitaliano stated that if returns are volatile, average returns are typically higher. Each market participant should favor as much volatility as he or she can stand from a cash flow perspective. If margins are low, volatility is more of a problem. Mr. Brown made the point that the nature of each farmer's or buyer's business will determine risk aversion. Mr. Schiek said that current proposals will not eliminate enough volatility for some individuals. He was of the opinion that dairy farmers need to get aggressive using risk management tools.

Concerning the position of the U.S. dairy industry in world markets, Ms. Pagel stated that there is difficulty meeting standards or producing what customers want. Southeast Asia, for example has much more stringent quality standards than the U.S. for some products. The U.S. produces nonfat dry milk (NDM) rather than skim milk powder (SMP) due to Federal standards of identity. Some buyers discount NDM relative to SMP because NDM does not have a standardized protein level. Dr. Yonkers believes that supply management could constrain exports as processors could be reluctant to contract for exports because of the possibility that they could not count on adequate milk supplies. Mr. Brown stated that if the U.S. is committed to growing trade, it will need to deal with trade access policies. Dr. Schiek emphasized that policies need to focus on allowing exporters to provide what customers in the world market want rather than concentrate on trying to sell existing products.

In responding to a question concerning standards of identity, Mr. Brown stated that products with a standard of identity are not necessarily better in quality than products without such standards, citing SMP as an example. Mr. Brown added that customers often want a specific product that likely does not have a standard of identity. Concerning imports, Mr. Brown stated that standards of identity are not a significant constraint, asserting that products will be imported one way or another. Dr. Vitaliano stated that the U.S. was once a magnet for imports because U.S. domestic product prices were consistently higher than world prices. This is no longer the case, and problems with imports have diminished over time. Ms. Pagel stated that Foremost is not opposed to standards of identity, mentioning that the prohibition of milk protein concentrates (MPCs) in natural cheeses, for example, has kept MPCs from displacing some domestic milk. Dr. Schiek emphasized that what makes a product high quality is whether or not the customer wants it.

In response to a question concerning FFTF, Dr. Vitaliano stated that the objective of FFTF is not to enhance prices. However, he believes prices will be enhanced because the program will allow production to respond to demand, thus helping to grow the market. He does not have disagreement with the models of Drs. Nicholson, Stephenson, and Brown, but he does not believe that the models can capture this type of dynamic.

Break, 3:00 PM

Subcommittee A Report and Discussion, Options Under Current Law, 3:30 PM

Subcommittee A made a draft report available to the committee concerning options available under current law.

Patricia Stroup discussed the document with the committee. She stated that Dr. Novakovic had crafted the paper based upon the subcommittee's informal discussions. The subcommittee does not yet have a "meeting of the minds." The document discusses such issues as the Dairy Product Price Support Program (DPPSP), the Milk Income Loss Contract (MILC) program, Federal Milk Marketing Orders, the Dairy Export Incentive Program, various Commodity Credit Corporation programs, and a variety of domestic and international food assistance programs. In conclusion, Ms. Stroup stated that not much can be done in the short-term to influence current prices or current margins because of budget constraints. The elements listed in the report for further consideration provide a starting point for discussion.

There were suggestions for the subcommittee to consider adding to the report. Edward Maltby suggested that the paper include a discussion of risk management that includes information about LGM-Dairy. He also suggested that the subcommittee consider looking into economic development funds that may be available.

Robert Wills asked if the Secretary has authority to allocate money for herd health issues such as tuberculosis and Johne's disease. Ray Souza stated that there was a program to help farmers with Johne's problems, but he believes that the funds have been exhausted. Perhaps it would be worthwhile for the subcommittee to examine what would be necessary for the Secretary to provide funding for the program.

There was considerable discussion concerning the relevance and purpose of Subcommittee A's report. Ms. Stroup noted a dichotomy: The subcommittee's report addresses the use of some programs that the committee may eventually recommend to eliminate. Sue Taylor stated that she believes the report should focus on what could be done now. Randy Romanski believes that the report should provide guidance for the Secretary in the event of another downturn.

Ms. Stroup asked Larry Salathe from USDA's Office of the Chief Economist to comment upon what funds may be available to assist the dairy sector. Dr. Salathe stated that presently there are no new appropriations for 2011 and the government will be operating under a continuing resolution for the foreseeable future. Every department will have the same budget as the previous year and that most of this money may have already been allocated. He stated that there may be some Section 32 funds available, but that these funds are usually for commodities that do not already have price support programs. Section 32 funds would not be available to buy products that are already purchased through the Dairy Product Price Support Program, but they could possibly be used to buy other dairy products. However, there is a fixed amount of money available, and producers for other commodities that traditionally have received assistance from the funds may object to assistance for dairy. He mentioned that Section 32 funds are sometimes used for disaster assistance. Mr. Romanski asked Dr. Salathe if the Secretary has the authority to declare an economic disaster rather than a weather-related disaster. Dr. Salathe stated that he does not believe that the Secretary has such authority.

Dr. Novakovic urged the committee to look at the draft report and to provide guidance as to the direction that the subcommittee should pursue. He mentioned that the challenge is to provide guidance for the Secretary in the event of another downturn given the current "tools in the toolbox."

Ms. Stroup thanked the committee for their feedback and stated that the subcommittee would consider the discussion, restructure the report, and bring it back for the full committee's consideration.

Adjournment, 4:00 PM

Friday, September 24, 2010

Call to Order, Solomon Whitfield, 10:40 AM

Dr. Novakovic made some opening announcements, stating that detailed minutes are on the Internet from past meetings and will be made available for this meeting. Comments may be provided to the committee by the public through email, web-based tools, or the U.S. postal service.

Subcommittee B Report and Discussion - Dairy Farm Profitability
Subcommittee C Report and Discussion – Price Volatility, 10:45 AM

Edward Maltby provided a presentation on behalf of Subcommittee B concerning dairy farm profitability issues. Much of the presentation concerned growth management, including ideas for how such a program would be operated, trigger points, goals, action steps, and questions that would need to be answered. Other topics of the presentation concerned farm savings accounts; somatic cell count standards; possible changes to Federal milk marketing orders; antitrust issues; Food and Drug Administration, Natural Resources Conservation Service, Environmental Protection Agency and individual state initiatives; and other program considerations.

Ray Souza discussed a proposal to adopt California nonfat solids milk standards for fluid milk on a national basis. He explained that in California nonfat solids are added to fortify milk that is reduced in fat content, with an aim to keep total solids content at 12 percent. This adds nutritional value to milk and has been popular in California. He mentioned a recent study by FAPRI indicating that adopting the same standards for the U.S. would increase producer revenue by approximately $510 million. He provided graphs to the committee as evidence that fluid milk consumption in California had not been adversely affected by fortification. He stated that additional work needs to be done to determine the costs involved in fortifying milk. He requested that USDA investigate the costs associated with fortifying fluid milk, including equipment costs.

Jay Bryant provided the presentation for Subcommittee C concerning price volatility. The subcommittee provided a draft report to the committee. The report specifically defined volatility and asserted that farm margin volatility is of greater concern than the absolute price level. The subcommittee proposed some policy parameters to consider in evaluating proposals. Their recommendations included a proposal to use farm savings accounts as a risk management tool, and a government guaranteed margin line of credit to cover futures margin calls. They believe that several items need further study including supply management, rural development goals, and modification of existing policies.

Dr. Novakovic stated that the subcommittees should think about what problems they are trying to solve. For example, cash flow coverage is not the same as profitability in the long term. The committee needs to consider what is meant by volatility. He stated that the committee is not bound to examining existing proposals. He sees four big areas of overlap between the two subcommittees: (1) growth management concepts; (2) farm savings accounts; (3) Federal order issues, including price discovery; and (4) risk management, including the margin line of credit proposal from Subcommittee C. He mentioned that Subcommittee A had previously talked about existing demand-based programs but that the other subcommittees had not discussed demand-based programs.

Sue Taylor suggested that the committee discuss the issue of whether or not there is a long-term profitability problem for the dairy industry, asserting that economists the previous day had indicated that there had been recent problems but that there had not been a profitability problem over the long term. The following were discussion topics:

- Robert Wills suggested that the committee keep in mind the comparison between market-based solutions and government-based solutions, realizing that neither is perfect and both have costs.
- Deborah Erb stated that, from her perspective, she had heard both yes and no answers from economists the previous day concerning the long-term profitability of dairy farming.
- James Krahn pointed to higher input costs that dairy farmers have experienced in recent years.
- Sue Taylor made a distinction between short-term problems caused by volatility and long-term profitability.
- Edward Welch asserted that the committee had already established that there was a profitability problem for farmers at the first committee meeting.
- Ray Souza was of the opinion that the extreme highs and lows are the problem. When prices are as low as they were in 2009, there is a profitability problem that is difficult to overcome.
- Patricia Stroup stated that the data indicate dairy is a profitable business in the long-run and that volatility is the real issue.

- From Dr. Novakovic's perspective, the profitability question is more about the correlation with or effects on the distribution of farms by size and location—how many farms there are and where they are.
- Ed Maltby said that the committee has not really answered the question of how regional distribution issues affect the rural environment, food security, and government policy moving forward.
- From Ricky Williams' perspective, volatility and profitability go together, stating that he took a "ten year step backward in equity" in 2009.
- Paul Bourbeau pointed to the decline in the number of farms as evidence of a profitability problem. He also discussed problems for dairy in credit markets. He questioned whether farms in recent years had been gaining equity due to rising real estate prices rather than from their dairy operations.
- Sue Taylor stated that consolidation in the dairy industry could be due to economies of scale rather than from a profitability problem.
- Timothy den Dulk stated that the problem is not one of large farms taking over the industry, pointing out that large farms that buy most of their feed have had significant problems.

Lunch, 12:00 noon

Subcommittees B and C, Continuation of Discussion, 1:45 PM

Dr. Novakovic invited the committee to discuss the topic of milk price volatility. The following highlights that discussion:

- Sue Taylor mentioned that Subcommittee C had included a definition of volatility in their report.
- Ed Maltby stated that the committee needs to consider defining a reasonable range of volatility.
- Robert Wills said that the committee needs to distinguish between volatility and variability, which may or may not be predictable.
- Dr. Novakovic discussed the concept of uncertainty in the context of price volatility. He mentioned that, at one time, there were policy tools to lessen price seasonality, which is relatively predictable.

Dr. Novakovic invited the committee to discuss growth management. Highlights include:

- Ed Welch pointed out that all of the analyses indicated that the proposed growth management plans would reduce volatility.
- Sue Taylor stated that the econometric models are not able to capture all of the details and that there is a possibility that the proposed programs may have unintended consequences.
- Dr. Novakovic discussed a supplemental analysis by Drs. Mark Stephenson and Chuck Nicholson which found that the effects on price volatility given the same government

expenditure levels are similar for the three proposed growth management programs they analyzed.

- Paul Bourbeau stated that when dairy farms go out of business it hurts rural communities; as a result, growth management is starting to be looked on favorably by many producer groups.
- Jim Krahn emphasized large differences in types of growth management programs, comparing the Canadian quota program with NMPF's proposal. He described the NMPF proposal as a safety net available for use in dire circumstances.
- Deborah Erb believes that the committee could agree on a proposal that would only be activated during catastrophes and work quickly with well-defined parameters.
- Jay Bryant stated that NMPF has cooperative members who support a growth management system and others who are against it. FFTF was a compromise. Likewise, the committee could reach a compromise, or as an alternative, offer a split recommendation.
- Robert Wills says that he is skeptical that the FFTF proposal is not a foot in the door to a more intrusive growth management system.
- Timothy den Dulk stated that under the FFTF plan, money could be taken from a farmer's check when he needs it the most. He does not believe the program would be effective in the aggregate since only small amounts would be deducted from a farmer's check.
- Patricia Stroup said that she has two concerns: 1) FFTF is not big enough to have an impact; and 2) FFTF will work but with a lot of unintended consequences. For example, an increase in milk prices might be offset by a decrease in cattle prices.
- Timothy den Dulk stated that dairy farmers may prefer the Costa-Sanders plan because the penalty money collected would be distributed back to producers who stay within their production limits. He does not believe the response for either plan would be very large.
- Deborah Erb and Paul Bourbeau believe that any program showing a negative number on a paycheck will affect behavior. Mr. Bourbeau elaborated that farmers will make necessary changes to reduce production if that means there would be no reduction in their paycheck.
- Sue Taylor responded that while farmers may make changes to ensure no reduction in revenue, if a growth management program is deactivated, then the changes may be reversed and production could then increase.
- Jim Krahn stated that the growth management programs would be in place to shorten the length of the price troughs. He is of the opinion that if demand increases as predicted, the growth management programs would not exist for long.
- Patricia Stroup stated that she would like to see an analysis of the impact of the proposed programs on cow values.
- Sue Taylor expressed concerned about a lack of milk supply during times when the proposed programs are in effect.
- Robert Wills stated that the committee needs to be concerned about the type of problem that a growth management program is trying to solve, asserting that the Costa-Sanders proposal does not distinguish between predictable variability and volatility due to shocks.

- Jim Krahn stated that NMPF's proposal has a "huge hammer," but it will not be in effect at times when dairy farming is profitable.
- Ray Souza stated that the committee may be able to reach a consensus on a program that is a safety net, but it will be difficult if it is approached from a point of enhancing producer revenue. According to Mr. Souza, the Costa-Sanders proposal would have more government involvement on an ongoing basis as compared to the NMPF proposal, which he described as more of a safety net.
- James Goodman was of the opinion that a program that looks at prices rather than margins would be simpler and more equitable for dairy farmers.

Dr. Novakovic summarized several types of risk management tools. Hedging is a tool that has been around for a while that can be accessed by any individual and can be facilitated by a cooperative, for example. He pointed out that one of the subcommittees had recommended the establishment of a government margin line of credit guarantee to help facilitate risk management. LGM-Dairy is a government program that is available, and some changes to the program will be effective soon. Adjusted Gross Income (AGR) Lite is another government tool that is available but is not specific to dairy. FFTF includes a margin revenue insurance plan that offers a low level of coverage (provided by the government) and the opportunity for dairy farmers to buy additional coverage.

The committee discussed risk management tools. Highlights include:

- Robert Wills was of the opinion that risk management perhaps contributes to variability because to some extent these tools insulate market participants from price changes. He questioned whether the government should have a role in facilitating risk management.
- Dr. Novakovic mentioned that subsidized crop insurance programs have been available for a long time with the general understanding that participation would be low without the incentive of a government subsidy.
- Ed Maltby stated that some of the existing programs are not available to all dairy farmers and that their complexity may be a deterrent to their use.
- Sue Taylor stated that the margin line of credit proposal is intended to provide a mechanism to make risk management tools more accessible.
- Jay Bryant believes that the industry would be helped by programs that would make risk management more user friendly.
- Robert Wills responded that risk management is not without costs and that subsidizing risk management really helps the participants get a higher return than they would otherwise get if they were bearing the costs for themselves.
- Sue Taylor clarified that the margin line of credit, as proposed, is not a subsidy program.
- Paul Bourbeau pointed out that many dairy farmers do not use the futures market to hedge risk because a previous experience caused them to miss out on a higher milk price when they locked in a price using the futures market. He added that the margin calls are an obstacle to participation in the futures market.
- Timothy den Dulk believes that the margin line of credit may facilitate risk management but there may still not be wide usage.

- Jim Goodman was of the opinion that farmers do not use the futures market to hedge risk, but rather as a gamble to get a higher price.
- Dr. Novakovic encouraged both subcommittees to reflect on the comments expressed by other committee members and incorporate them into their reports.

Patricia Stroup discussed a paper by Dr. Stephenson and Dr. Nicholson that had been passed out the previous day but had not been discussed. She said that it appears to show that farm savings accounts have similar impacts on volatility as the growth management plans that were discussed. She asked Dr. Novakovic to elaborate on the analysis. Dr. Novakovic responded that the analysis was done at his request. The analysis assumed that farmers would set aside pre-tax farm earnings in a special "farm savings account" that could be withdrawn later as Schedule F income, and then subject to tax. The analysis also assumed a level of government matching of farm deposits that was based on the $100 million per year government spending limit that was also used to compare other alternative proposals. The model predicted that volatility would be reduced because there would be less incentive to increase production in years when net income was diverted to savings. Costs of the government would include tax revenue implications and costs of the government match, if there was one. An analysis was not done to estimate the implications for such a program for US tax revenue but it is quite likely that such effects would be minimal because taxes are only deferred, not eliminated, and farmers currently employ other mechanisms to avoid taxes in high return years. Income eligibility rules could be applied to such a program in order to limit the budget impact.

The committee discussed farm savings accounts. Highlights include:

- Paul Bourbeau stated that he would be in favor of farm savings accounts but that he would be opposed to a government match.
- Randy Romanski made the point that the government funds used for a match in farm savings accounts could come from reductions or eliminations of other programs such as MILC or DPPSP.
- Jim Goodman urged caution in implementing such a program, mentioning the Payment in Kind (PIK) program as an example of a program that had problems with people gaming the system.
- Ricky Williams stated that, given the recent downturn, it will be a long time before many dairy farmers will have money available to put into a savings account.
- Patricia Stroup added that the goal of a farm savings account would not have been to give farmers money in 2009. It would have been so that farmers could have saved money in 2007 to take out and use in 2009.
- Timothy den Dulk stated that, aside from the match idea, he cannot think of anybody who would be hurt by such a program, and it would be available to help dairy farmers in the future.

Break, 3:15

Subcommittees B and C, Continuation of Discussion, 3:40 PM

Dr. Novakovic asked the committee to discuss Federal order pricing, other pricing issues, and competition issues. Discussion highlights include:

- Sue Taylor said that she believes that the Federal order system is leading to greater volatility because milk is not moving to its highest valued use.
- Robert Wills asked about the feasibility of bringing in some experts to discuss marketing orders.
- Deborah Erb suggested that someone from NMPF come in to give an update on their FFTF competitive pay price proposal.
- Ed Welch said that NMPF is not very far along in their proposal regarding marketing orders.
- Jim Goodman suggested that it would be good to have panelists from the USDA-DOJ hearing to come in and talk to the committee: Bob Cropp, Ron Cotterill, and Peter Carstensen.
- Committee members listed topics for which they would like further discussion including make allowances, depooling, pool loading, multiple manufacturing classes, the use of the "higher of" for Class I, pool qualification criteria, and concentration issues related to Federal orders.

Dr. Novakovic asked the committee for other issues that one or both subcommittees should consider. Other topics discussed by committee members included rural development policies, replacing the DPPSP and MILC programs with a margin insurance program, raising fluid milk solids standards, NASS surveys, and demand-enhancing programs.

Dr. Novakovic stated that a goal of the October meeting is to clarify the scope of the final report. He made an outline for a final report available to the committee that includes section headings. He indicated that the outline is open for discussion and can be changed as the committee sees fit.

In response to an earlier inquiry, Dr. Novakovic stated that he has been told that the $60 million for cheese purchases that Congress appropriated for food assistance programs has been committed and most of the product has been purchased and distributed.

Adjournment, 4:15 PM