

Testimony
Presented to:
Pennsylvania State Senate Agriculture and Rural Affairs Committee

Presented by:

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Chairman Brubaker and Chairman O’Pake, members of the Pennsylvania State Senate Agriculture and Rural Affairs Committee, thank you for inviting me to appear before you today. The dairy industry in Pennsylvania continues to face the ups and downs of the market place. Milk prices are driven by domestic and international supply and demand factors. Pennsylvania dairy producers may receive very good prices one year, resulting in high returns on equity and even expansion in production capacity. But milk prices can also fall to very low levels resulting in economic losses and the need to refinance the dairy operation. I am pleased to say that the market is now in a very favorable position for dairy producers. Milk checks in Pennsylvania will rise to very high levels throughout the balance of 2007. Despite paying higher feed bills, I expect milk producers will be in a position to regain some of the losses suffered in 2006.

Milk production in Pennsylvania was on a steady decline, falling from 11.156 billion pounds in 2000 to 10.062 billion pounds in 2004. Pennsylvania milk production then grew to 10.742 billion pounds by 2006. For the first quart of 2007 milk production is down 2.2 percent from the first quarter in 2006. Our industry tends to grow when milk prices are good, but declines when prices are low.

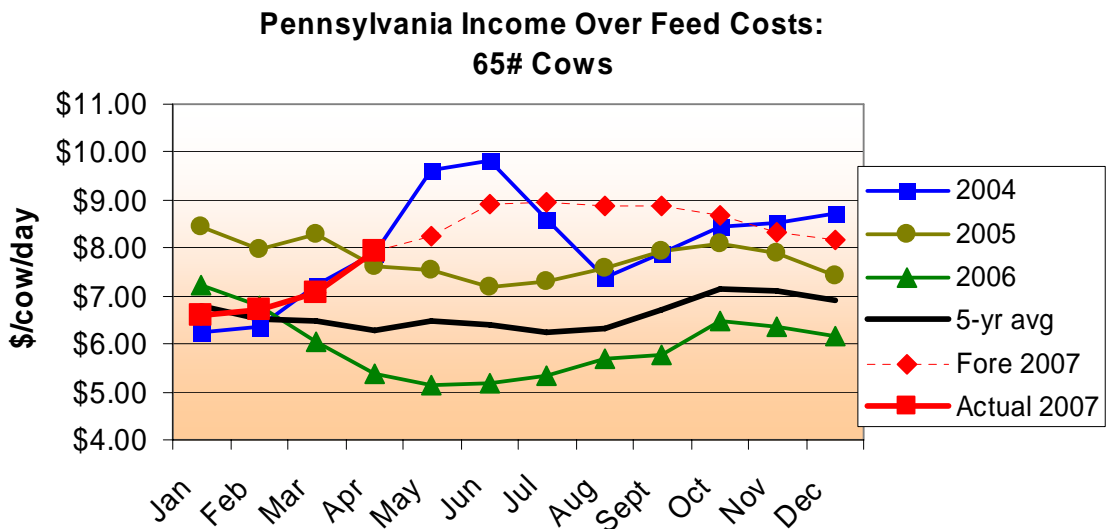
Generally speaking milk producers in Pennsylvania have difficulty cash flowing their operations whenever the Pennsylvania all-milk price falls below \$14.50 per one hundred pounds of milk (referred to as “cwt”) in any one month. The Pennsylvania all-milk price averaged \$15.30 per cwt over the period 2000-06. More recently, milk prices were very good in both 2004 and 2005, averaging \$17.62 and \$16.85 per cwt, respectively. However, milk prices never remain high forever. The Pennsylvania all-milk price fell to \$14.60 per cwt in 2006. Low milk prices in combination with escalating corn and soybean prices in the fall resulted in economic losses for many Pennsylvania dairy farms in 2006.

It is important to have a measure of profitability of Pennsylvania dairy farms. One measure of profitability is our Penn State estimate of Income Over Feed Costs (IOFC). This is simply the value of 65 pounds of milk less the feed cost of producing that milk. Sixty five pounds of milk is what a typical Pennsylvania dairy cow will produce in one day. Our estimates are that IOFC in Pennsylvania fell from an average \$7.97 per cow per

day in 2004 to \$7.84 in 2005 to \$6.10 in 2006. In other words, in 2006 the average cow had gross earnings on a daily basis that was \$1.74 less than what that same cow earned in 2005.

One reason for such low milk prices in 2006 was because the supply of milk in the U.S. grew 2.7 percent ahead of 2005. Milk production normally grows at a rate closer to 1.4 percent each year. Such growth in the milk supply resulted in expectations of lower market prices for cheese, butter, nonfat dry milk, and dry whey. That translated into lower U.S. average milk prices. Despite the rapidly rising milk supply, growth in market demand was good during 2006. Domestic commercial disappearance as measured by Penn State showed very positive rates of growth for fluid milk, American cheese, and butter. Also, export sales of skim milk powder were steady and sales of dry whey, lactose, and whey protein concentrate were very strong. Thus it was surprising to see milk prices as low as they were.

The outlook for milk prices and farm profitability has greatly improved this year. Using contract prices at the Chicago Mercantile Exchange, the market expects the Class III price for milk used for cheese production to average \$17.11 for all of 2007. That would represent a 43 percent increase over 2006 levels. Thus the Pennsylvania all-milk price is forecast to be \$19-\$19.60 per cwt in 2007. This is well ahead of the average Pennsylvania all milk price of \$15.30 per cwt for 2000-06. In addition, using these futures prices, I am forecasting that IOFC in Pennsylvania will reach \$8 per cow per day in 2007, well above the five year average (see Figure). Since IOFC is a measure of gross profitability, I believe that projected market prices for milk and feed for the remainder of 2007 will result in better economic returns this year.



A major factor contributing to higher milk prices this year is strong global demand for milk proteins in combination with limited production. The European Union is allowing less surplus dairy products to be exported onto the world market. In addition, another severe drought in Australia is limiting milk production there. Strong growth in the global economy is resulting in greater demand for dairy products from countries such as China, other Asian countries, and oil exporting countries. As a result, the U.S. is exporting all the excess skim milk powder, lactose, dry whey, and whey protein concentrates that we have. These countries are using these products to not only improve the diets of their populations, but also for livestock feed.

Despite these very rosy economic projections, Pennsylvania dairy farmers are very frustrated with their current economic conditions. Poor cash flows in 2006 and rising feed prices have resulted in adverse changes to the balance sheet. Adding to this poor economic performance has been recent management decisions by USDA that has resulted in less money ending up in the milk check. USDA made a decision to raise the “make allowance” for processors located in federal orders just when Pennsylvania milk producers were reaching a critical point in poor cash flow. Cheese processors located in New England and the Upper Midwest petitioned USDA for higher make allowances in order to retain more money from federal order pools to offset rising production costs. As a result, starting in February 2007, roughly \$0.25 per cwt was effectively deducted from the milk checks of milk producers located in Federal milk marketing orders. Much of Pennsylvania’s milk was affected by this decision.

USDA also made a mistake in how they survey plants that manufacture nonfat dry milk. These plants are supposed to accurately report sale prices each week to USDA. But they under reported these prices to USDA in March 2007. As a result USDA announced they will be making changes in the reported prices in March. These survey prices are important in that they are used in federal order formulas that determine Pennsylvania milk prices. By my own estimates, I calculated that USDA began under reporting milk prices starting back in August 2006 when NASS survey prices lagged behind spot market prices and international market prices by about 4-15 cents per pound. That difference between the NASS survey price and the spot market price got even worse in recent months when the difference rose to 20-45 cents per pound. I estimated that this difference cost milk producers in federal orders roughly \$209 million between August 2006 and April 2007.

Another problem in the present milk pricing system is that dairy processors have an obvious incentive to direct their sales staff to sell dairy commodities—cheese, butter, nonfat dry milk and dry whey—at their lowest price. That’s because when a plant reports a sale, that sale price goes into a federal order formula that determines what the plant must pay milk producers for their milk. For example, if a large processor of dry whey reports a large increase in the sale price of dry whey, the processor will end up paying much more for milk needed to make the whey. This incentive by processors to under report the true market value of dairy commodities has possibly reduced milk prices at a time when dairy farmers needed it the most.

All of these pricing problems raise the issue of milk pricing reform. Secretary Wolff has taken on national visibility in recommending specific changes to milk pricing under a reform plan that is being considered as part of the 2007 Farm Bill. The general themes of this dairy reform plan are to strengthen the safety net for producers, improve the federal order system, provide for improved price discovery, and develop new export markets. In my opinion these reform plans are well thought out, economically sound, and address the problem at the national level. ***If Pennsylvania dairy producers are to benefit from policy changes that improve the pricing system, these changes must be made at the federal level.***

One element of Secretary Wolff's plan is to move away from a weekly NASS survey of plants to mandatory daily reporting of all dairy transactions. This would be similar to the present system of livestock market reporting. This one change will eliminate the current problems with under reporting. If a plant either does not report a sale or under reports a sale, than they will be liable to damages under the proposed law. Also, having all sales transactions reported will provide the entire U.S. dairy market with accurate information regarding what dairy commodities are worth. This will greatly benefit dairy farmers who want to be paid on the basis of the market value of their milk and milk components.

Another problem is that Pennsylvania dairy farmers have limited market intelligence in which to make sound business decisions on forward pricing their milk and feed costs. Clearly this will be increasingly important for our industry given current volatility in milk prices. But the problem is the U.S. dairy industry is very complex and basic information, such as supply and demand tables for milk and dairy commodities are not readily available. Unlike the grain markets which have this information, the U.S. dairy industry lacks good solid analytical models, supply and demand tables, and expert advice on market direction.

The current problems with the NASS survey, the federal order hearing process, and general lack of market intelligence raises the issue of the need for a central clearing house of economic information for the U.S. dairy industry. I have proposed creating a National Center at Penn State University (**U.S. Dairy Industry Center**) that will track and report short-term market fundamentals of the U.S. dairy industry, analyze the impact of trade on U.S. dairy markets, and analyze short-run policy impacts on milk producers, processors, and consumers. Currently the USDA's Economic Research Service is providing Penn State modest funding to create both a U.S. dairy industry database and an economic model for use in price forecasting. ERS is using this information in their monthly responsibilities with USDA's World Board. But that support will likely run out in January 2008. What is needed is state support to continue this important activity of generating market analysis, models, and price forecasts. By providing this support Pennsylvania dairy producers will have better information in which to make key business decisions. Also, Pennsylvania will take on national prominence in providing national market intelligence on the economics of the U.S. dairy industry.

The dairy industry continues to be a vital economic engine of growth for the state of Pennsylvania. Unlike what some may think, the dairy industry in this state is a growth industry. In 2006 Pennsylvania milk was worth \$1.6 billion in a bad milk price year. Even with a modest economic impact multiplier of 2.5, that represents \$3.9 billion in total statewide economic sending. There is strong regional demand for the milk produced in our state. While surrounding states continue to lose milk production, we are called on to balance the needs of milk consumers as far away as Florida. But the fate of Pennsylvania's dairy industry continues to sway with domestic and international market forces. In other words, we have little control of our own milk prices since they are in large part determined at the national level. The good news is that current market forces are expected to drive Pennsylvania prices to profitable levels for the balance of this year. However, we must be vigilant in re-examining our current milk pricing system and making sound recommendations at the federal level for needed improvements. In addition, the Pennsylvania dairy industry is in need of good market intelligence in order to better access the futures market and make sound investment decisions.

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