International Dairy Foods Association
Milk Industry Foundation
National Cheese Institute
International Ice Cream Association

Blue Bell

Statement of Paul Kruse
CEO and President
Blue Bell Creameries, L.P.

Before the Subcommittee on Domestic and Foreign Marketing, Inspection and Plant and Animal Health and the Subcommittee on Production, Income Protection & Price Support

Committee on Agriculture, Nutrition and Forestry
United States Senate
October 27, 2009

Madam Chairwoman, Mr. Chairman and members of the subcommittees, thank you for the opportunity to appear before you today. I am Paul Kruse, the CEO and president of Blue Bell Creameries based in Brenham, Texas. We are a regionally based company with manufacturing and distribution facilities across 18 states in the South and Southeast United States, including Arkansas and Georgia, the states of the Chairwoman and Ranking Member of the Senate Agriculture Committee. Blue Bell has been in business since 1907. Today the company manufactures a full line of ice cream products and is recognized as the third largest ice cream brand in the United States.

I am also speaking today as chairman of the International Dairy Foods Association. IDFA's 220 dairy processing members run more than 600 plant operations, and range from large multi-national organizations to small single-plant companies. Together they represent more than 85 percent of the milk, cultured products, cheese and frozen desserts that are produced and marketed in the United States.

I appreciate this opportunity to address our nation's current low dairy prices and potential reforms of our federal policies that will address some of the problems in the dairy industry. I would like to first give you a brief overview of the industry and the trends that have brought us to where we are today.

It is our view that our nation's dairy policies are not only failing to provide stability to the industry but are also standing in the way of our industry's enormous opportunity for expansion, something that will greatly benefit both dairy producers and processors.

Our government spends considerable resources on existing dairy programs. During this calendar year, payments to dairy farmers under the Milk Income Loss Contract program will total nearly $1 billion. Last fiscal year, the USDA spent nearly $270 million to purchase products under the Dairy Product Price Support program and just a few weeks ago, Congress appropriated an additional $350 million for additional direct payments and dairy product purchases.

Dairy remains a key component of our nation's agriculture industry. Nationwide, the dairy industry employs hundreds of thousands of people on farms, in processing plants, through marketing and transportation, in retail stores and in companies that supply inputs to the dairy industry. Dairy processors are in the middle of this equation. We depend on our dairy farmers and cooperatives for a reliable and high-quality milk supply to make our products. We have developed tremendous trust and reliance in these relationships. At the same time, our customers depend on us to deliver the nutritious and delicious products they want.

We are deeply concerned about the situation dairy producers face today, and want to help find solutions that will help all producers, both large and small, have the necessary tools to manage their businesses profitably. There is not a dairy product manufacturer in this country who takes for granted the great resource we have in our U.S. milk supply or the dairy farmers and their families and cooperatives that make it possible. This partnership between milk producers and milk manufacturers is critical, and the policies and programs that you consider here on Capitol Hill can affect that partnership in both positive and negative ways.

Today's Dairy Industry

There are different ways of measuring how farm milk is used, but roughly 45 percent of domestic milk production is used for cheese; 30 percent for fluid, or beverage milk, and 10 percent for frozen products like my favorite dairy product, ice cream. The remaining 15 percent is used for butter, nonfat dry milk and other products.

Although nearly every state, including Alaska and Hawaii, has at least a few dairy farmers, nearly three quarters of our nation's milk production currently comes from the top ten dairy states of California, Wisconsin, Idaho, New York, Pennsylvania, Minnesota, Michigan, Texas, New Mexico and Washington.

Dairy processors, as one would expect, are clustered in these same areas. As an industry, dairy processors directly employ over 120,000 people. Growth in milk production is now most often driven by investments in new dairy plants or increased capacity in an existing one. Some states are taking steps to reverse or stem the decline in milk and dairy processing capacity, looking to create more demand for milk, new jobs and long term economic growth.

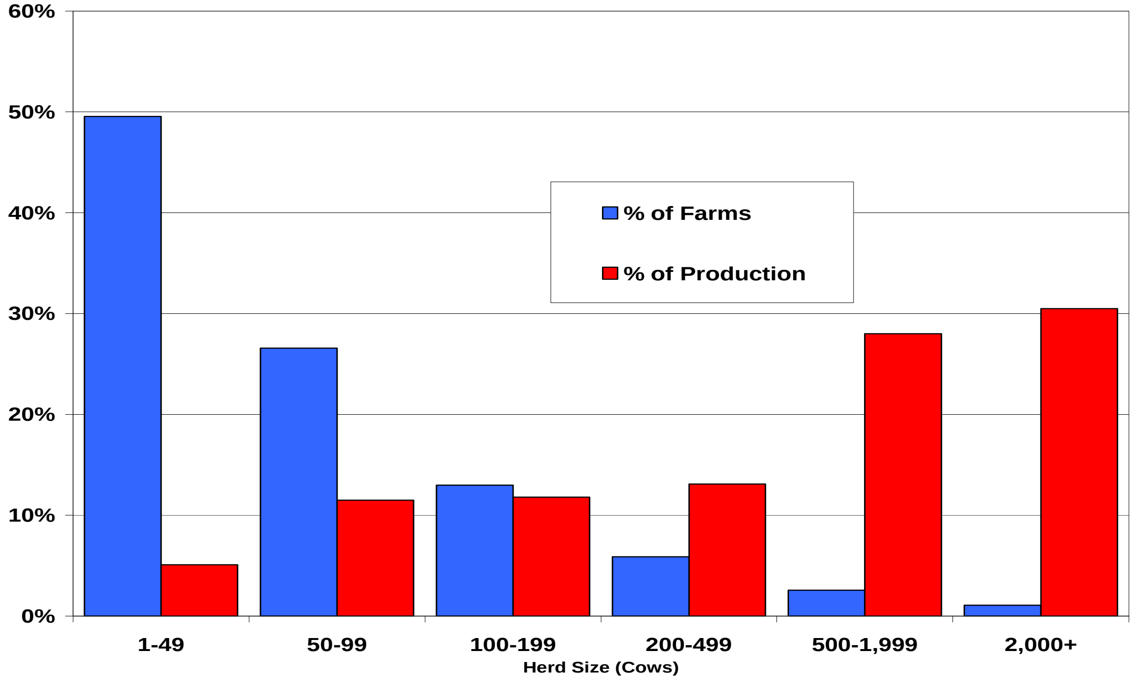
Decades ago, most dairy products were only marketed locally or regionally, but with advances in transportation and efficiencies in production, most of our dairy products are now marketed regionally and nationally. In addition, a growing global market has increased demand for products such as milk powders that can be easily incorporated into many other food products. Last year over ten percent of the U.S. milk supply was exported in the form of dairy products.

The dairy industry is defined by a few fundamental trends that often explain governmental policy towards the industry.

- The number of dairy farms has decreased dramatically over the last several decades. When federal dairy programs were first established some 70 years ago, there were over 4.6 million dairy farms and 22,000 dairy plants to serve our population of 132 million people (1940 data). We now have around 67,000 dairy farms, and about 1,200 dairy plants to support nearly 300 million people. Most states have witnessed a constant and steady decline in the number of dairy farms and dairy plants over several decades.

- The majority of milk production has moved from small dairy farms to large ones. In 2008, almost 59 percent of farm milk production came from only 5 percent of our dairy farms, those with over 500 cows. In 1940, less than 1 percent of farms had 30 or more dairy cows, and over 90 percent of milk production came from farms with fewer than 30 cows. The rapid growth of the nation's dairy industry over the past few decades, especially in the Western states but a trend everywhere in the country, is almost entirely due to the development of very large dairy farms of 5,000, 10,000 or even 15,000 cows.

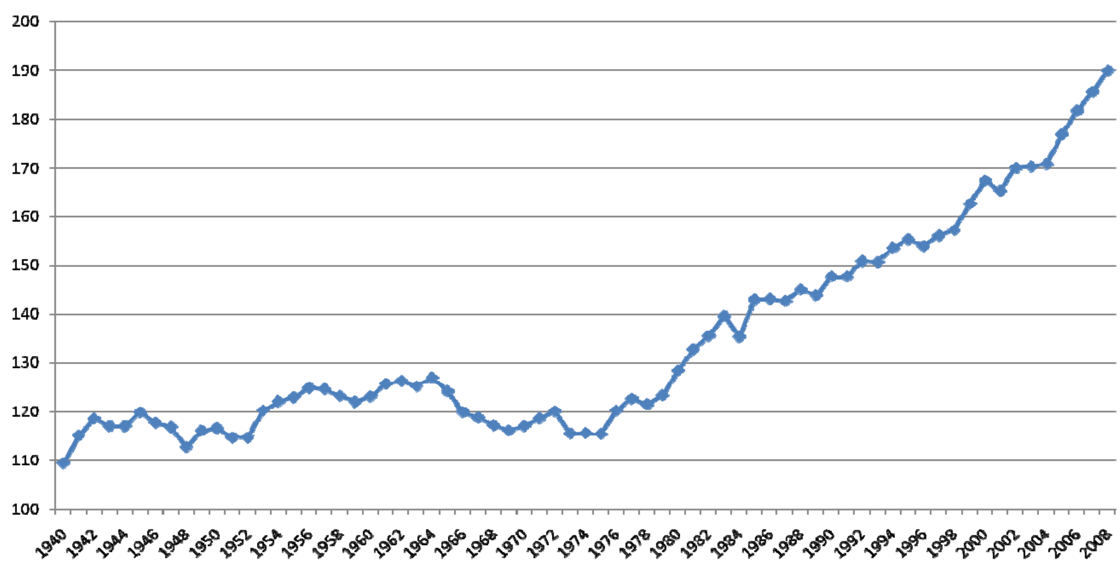
Number of Farm Operations with Milk Cows by Herd Size



Source: USDA, NASS

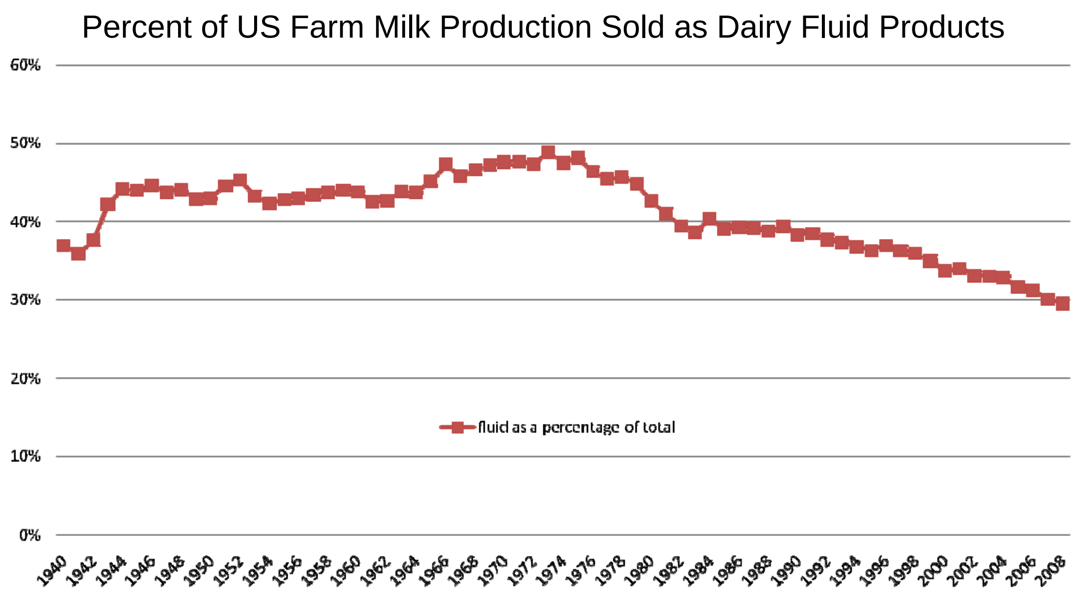
- For decades, these changes in the dairy farm sector, combined with an overall decline in per capita consumption of all milk and dairy products, limited overall growth in the industry. Total U.S. milk production was held to around 120 billion pounds between 1940 and 1975. Since then, milk production has soared and continues to grow annually.

Total Farm Milk Production



Source: USDA, NASS

- While farm milk production has increased dramatically, the percent used in fluid dairy products fell from nearly 49 percent in 1973 to below 30 percent in 2008. Annual fluid milk consumption has fallen from 30 gallons per person in the early 1970s to barely 20 gallons per person today. With population growth, this means that total fluid milk sales in the United States have been stagnant for decades.



Source: USDA, NASS

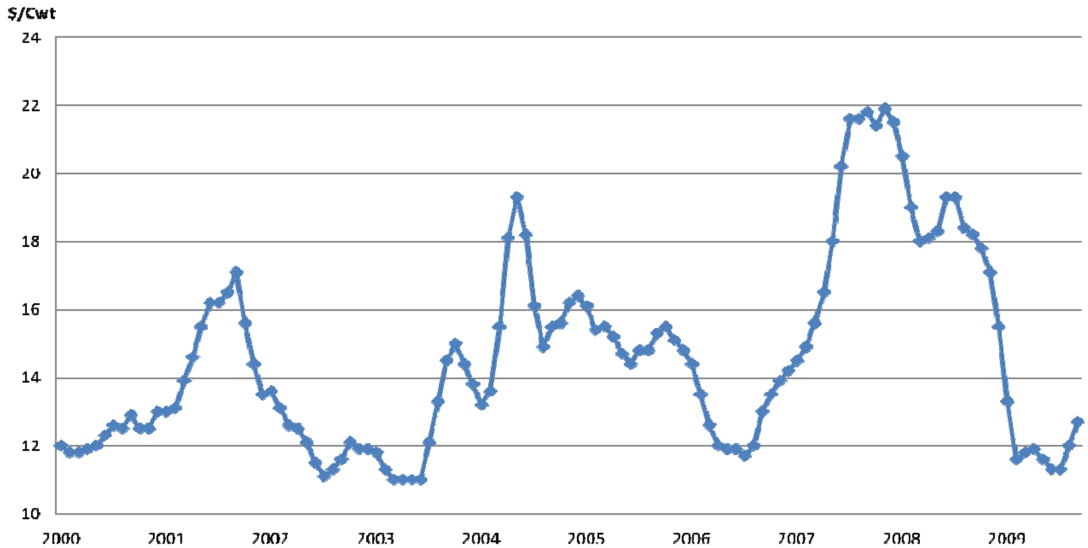
- As for other dairy products, cheese sales have significantly increased and account for nearly all of the growth in total dairy sales over the past few decades. Of particular interest to my company, per capita frozen dairy product production has declined over the past 25 years, from 25 quarts in 1985 to less than 20 quarts today, but total production has remained relatively steady in recent years thanks to population growth.

Dairy Lacks Risk Management Tools: Other U.S. Commodities Manage Greater Price Volatility

Milk price cycles are not unexpected. In fact, the U.S. dairy industry has a long history of price cycles.

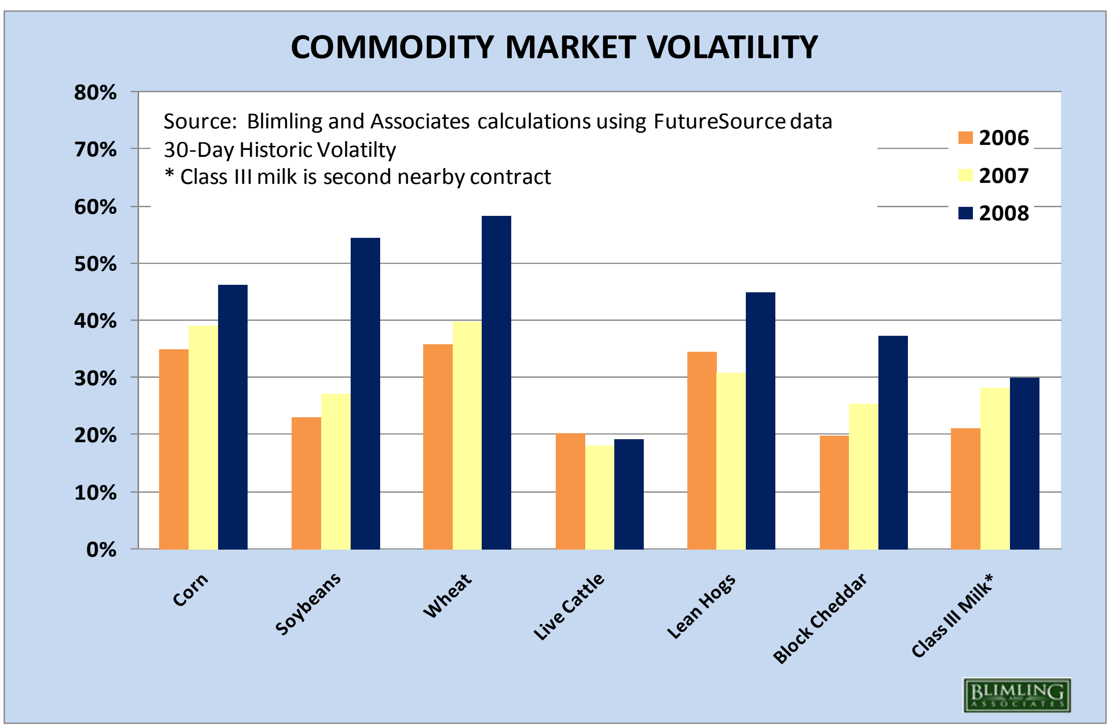
Just five years ago, farm milk and dairy product prices soared to then record-high levels where they stayed throughout 2004 and 2005. But that two-year period of high prices was followed by low prices in 2006. Starting in 2007, the pattern repeated itself. The record high prices in 2007-2008 have been followed by the low farm milk prices seen so far this year.

All Milk Price Since 2000



Source: USDA, NASS

Of course, price swings are nothing new for any farm commodity. But what most people do not realize is that, as shown by the graph below, other agriculture commodities have even wider price swings than dairy. So, why isn't Congress hearing as much from those other farm sectors than they are from dairy? The answer is that our dairy industry remains burdened by policies created over a half century ago.

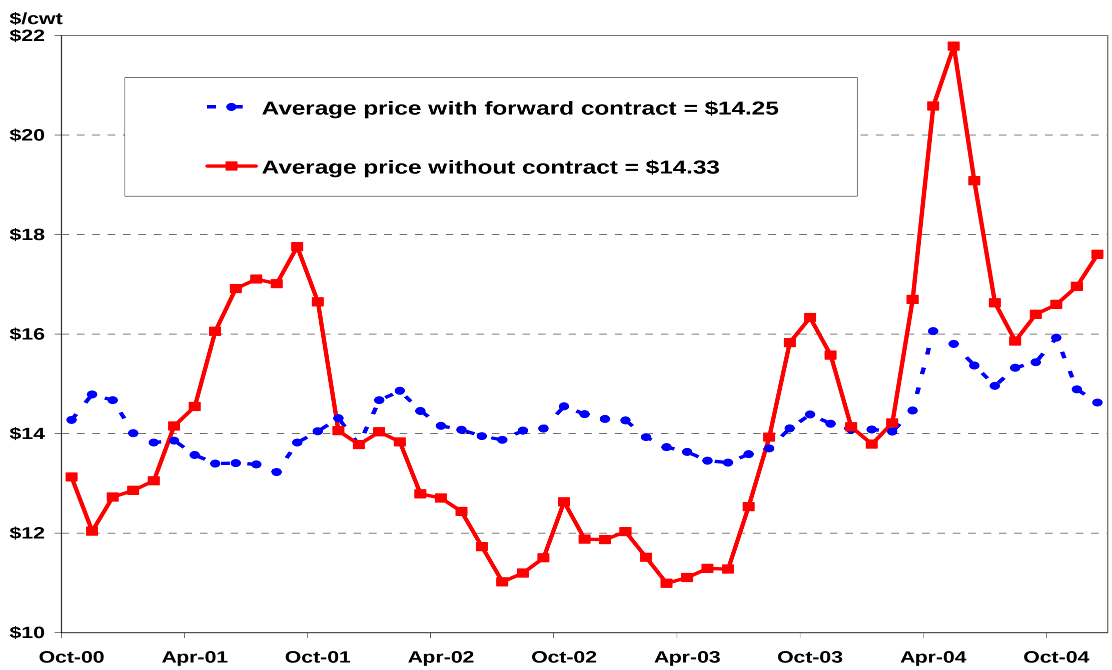


Our complicated milk price regulations make it much more difficult for dairy farmers, processers and end users to understand how existing dairy futures contracts relate to the milk price on their farm or the dairy product they make or buy. In addition, there are eight different dairy futures contracts to choose from, which means trading activity is spread thinly across those eight contracts. Compare this for example with corn, where there is only one futures contract and no regulations that price parts of each farmer's crop based on whether it is used to make ethanol, high fructose corn syrup, breakfast cereal or fed to cattle.

Milk price volatility is a serious problem for everyone in the dairy industry. Without adequate price discovery and risk management tools, every segment of our industry suffers through the price swings, especially the small producers and small processors. Price volatility makes it very difficult to plan for long term industry infrastructure investments, to capture and keep new markets for dairy products, and to compete with other commodities and foods that have less volatility.

We salute the Obama Administration expanding insurance programs like the "Livestock Gross Margin Insurance Program". And we congratulate Congress for providing dairy farmers with risk management tools such as the forward contracting program that was reinstated for some of the dairy sector through the term of the 2008 Farm Bill. Forward contracting is one of the most important tools that dairy farmers, processors and manufacturers can use to mitigate price swings. This chart, which uses data that the United States Department of Agriculture collected during the forward contracting pilot program, illustrates how risk management tools can be effectively used.

Market Risk Management Tools Have Helped Dairy Farmers Reduce Volatility



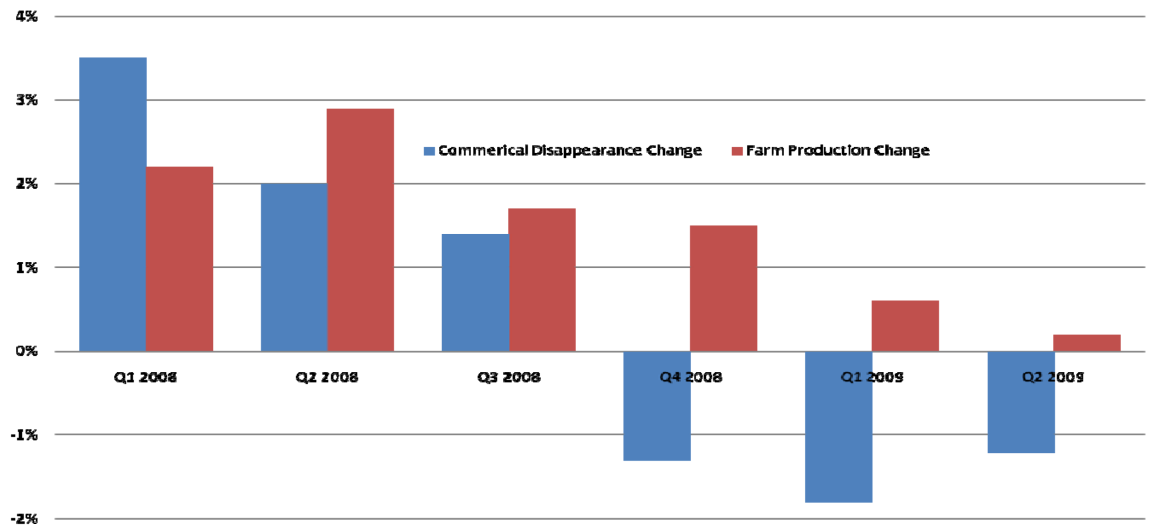
Source: USDA, AMS Dairy Forward Pricing Pilot Program: Information for the Complete Program Periods, September 2000 through December 2004

However, much more could be done. Simplifying the complex milk price regulations is becoming a cry across the dairy industry. This would allow fewer and more useful futures contracts to emerge. Providing greater education to dairy producers and processors about the need for using risk management and the tools available is important, as is providing the right insurance products and helping educate dairy farmers about their use as has been done with other commodities for many years.

Consumers Are Buying Less Dairy, Export Sales Are Off

Although too much supply has been tagged by many as the root of our current low farm milk prices woes, it is more complicated than that. The current economic downturn has greatly affected domestic and global demand for dairy products. The chart below shows that demand for dairy products started to slow down in 2008 and actually decreased in the fourth quarter compared to the same period a year earlier. This decrease has continued so far in 2009.

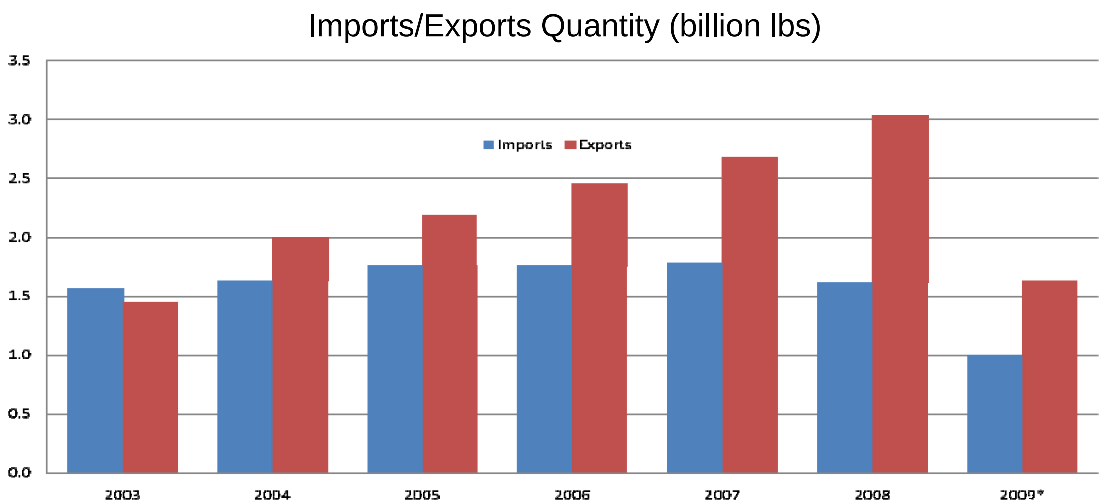
Milk Supply and Demand Changes vs. Same Period One Year Ago
(sum of milkfat and nonfat solids)



Source: USDA, Economic Research Service

The same negative economic forces we see in our domestic markets have led to the decline this year for both U.S. dairy product exports and dairy imports. Our dairy exports increased to record levels in recent years, but are lower so far this year. Imports have declined as well. The volatile and complicated pricing system, and the standards of identity that are outdated and not in sync with international demand, will continue to stymie our ability to retain and capture even larger segments of the growing international market.

In 2003, the United States imported a greater quantity of dairy products than we exported, and much of those exports were only possible due to subsidies under the Dairy Export Incentive Program. By 2008, the total quantity of U.S. dairy product exports had more than doubled, without any export subsidies. The U.S. Dairy Export Council estimated that in 2008 the United States exported more than 10 percent of its milk production as dairy products, while imports have remained around 5 percent of domestic dairy product demand in recent years.



Source: USDA, FAS

Potential for Growth – But Not with Supply Management

There is good news on the horizon. Milk prices have been steadily climbing over the past few months. Domestic demand for dairy products is increasing. And, as the world's economy continues to rebound, expanding middle-class populations in many nations, particularly in Asia, will help to increase worldwide demand for dairy products.

The United States, which already produces more cow milk than any other country, is uniquely positioned to capture these rapidly growing markets. Other major dairy exporting areas, such as the European Union, New Zealand and Australia, are held back in some way. Relatively new entrants to the world's dairy markets, such as Brazil, Ukraine and Belarus, are still in the early stages of growing their industries.

Yet, there are proposals, being considered by some in the producer community, that will result in turning our backs to this opportunity for expansion. The basic idea behind these proposals is that our government, or even worse an industry appointed board, must manage the supply of milk so that milk prices are guaranteed to cover the cost of production. For example, one plan calls for a cap on the supply of farm milk by applying a tax on milk produced above a level set to meet a calculated average cost of producing milk. However, doing so means that larger and lower cost producers make even more profit at the expense of consumers and the loss of export markets. In the Canadian system, which tries to do this, we have seen efficient dairy producers pay $27,000 per cow for the marketing quota to sell milk. Canadian processors, unable to source Canadian milk, are investing and expanding in the U.S.

The public policy implications of such proposals are profound and the inequities they would create are mindboggling. Programs that manage supply or limit milk production would raise milk and dairy product prices for our nation's consumers and would encourage them to purchase less costly and often less nutritious foods. Propping up domestic milk prices to levels above world market prices surely would cause the U.S. dairy industry to lose enormous opportunities for export growth and to open our markets to increased imports. Jobs that could be created here in the United States would be going elsewhere.

Dairy processors are particularly concerned that taxing new milk production to manage milk supply will limit the industry's ability to innovate and grow. Innovative new products need to tap new milk production, but no one can predict the pace of innovation or the size of markets for such products other than the marketplace itself. It is easy to foresee a supply-managed future where new consumer products are formulated so that no dairy is used to avoid the complications of pleading with a government agency or industry board for more farm milk. Taxing increased milk production will limit growth in both farm production and new plant investments where the market suggests they be made. Instead of rising to the challenge of capturing new domestic and international markets, a federal policy of mandatory quotas or taxes on increased supply would penalize areas of the country that are increasing production, such as Wisconsin, and those states that are attempting to revitalize their dairy sectors, such as New York, Pennsylvania and Vermont.

Current Dairy Programs are Failing

Our outdated dairy programs stand in the way of our industry's ability to manage price volatility. They are limiting our ability to expand demand for dairy both domestically and internationally. They significantly distort the market for dairy products and limit our industry's ability to fully take advantage of our trading opportunities and to respond to our competition for new food products here in the United States.

Innovative dairy companies around the world have developed new dairy ingredients that are increasingly used in popular products, such as protein enhanced waters, sports drinks, power bars, coffee drinks, cake mixes and crackers, to name a few. Even traditional dairy products are diversifying to meet consumer demand for non-traditional attributes, such as new sizes, flavoring, shelf stability and functionality. But our U.S. industry lags behind other countries in new product development and lags behind in innovation.

Why? First, our Dairy Product Price Support program encourages the production of nonfat dry milk, even as few food processors want to use that product. On the other hand, there is growing demand for products like milk protein concentrates which many food processors now source from other countries because the United States does not produce near enough. Simply put, our policies encourage investment in plants to produce nonfat dry milk and not the specialized milk proteins demanded by today’s marketplace. Our problem is not that our domestic industry can't compete with imports but that our government encourages the production of other products.

Federal Milk Marketing Orders also limit new investments into the dairy industry by creating unnecessary financial risks for many dairy manufacturing plants. Current government price formulas limit returns on investment which in turn has a major impact on investment decisions. It's the pricing formulas, believe it or not, that influence the type of dairy products to be manufactured and often the location of plant infrastructure. There is a built-in disincentive to manufacture high-value dairy protein ingredients, such as whey protein isolates and milk protein concentrates, because the value of these products are not captured in the formulas. But these are the very products that are increasingly being used in cutting-edge domestic consumer products like energy bars and sports drinks.

Avenues for Growth and Innovation or Managed Supply and Price?

Our dairy industry needs to make a fundamental decision about its future. Where do we want to go? Do we want an insulated, domestic oriented industry with even greater government intervention in pricing, product inventory management, and now farm milk supply controls? Or do we want to proceed down the path of greater opportunity and growth, for dairy farmers and dairy processors, large and small. The majority of milk and dairy product manufacturers in this country would like to see Congress assist the industry by providing the necessary tools to let the dairy industry respond to and meet the demands of a growing domestic and international dairy marketplace. This won't guarantee that all dairy farmers will be profitable but it will give everyone an opportunity to succeed.

The way to start is to stop treating dairy as different from other commodities. We need to help dairy farmers by giving them the ability to manage the unavoidable swings in market prices. Our system must not only allow but encourage the use of market-based risk management tools that allow dairy farms, processors and end users of dairy products (restaurant chains, supermarkets, further food processors) to manage variability in market prices. Every other agricultural sector can and does use such tools as a regular part of business and marketing plans. The federal government can help by providing more programs to manage risk and provide more funding to encourage their use.

Then, we need to fundamentally reform many of our other dairy programs to enable the industry to move forward. We need to simplify our Federal Milk Marketing Order system by reducing the number of classes and by eliminating the complex price formulas that are used to establish class prices. And, we need a system that will allow and encourage farm milk to move to what the market determines is its highest and best use, whatever product that is or wherever that plant is. Federal policy should be regionally neutral and not tilt production or investment decisions.

If as an industry we choose to have the government limit the milk supply in vain attempts to try and guarantee stable and higher farm milk prices, our dairy industry will not only stop growing but slowly decline as domestic and world markets are captured by our competitors. To see how this works out, we only have to look north of our border to

Canada, where total milk production is lower now than before supply controls began 30 years ago, where exports have fallen and imports increased, and where the dairy trade deficit is growing larger over time. On the other hand, with the right policies and programs in place, our U.S. dairy industry will be able to retain and gain customers, both here and abroad, by providing traditional and innovative products that address nutritional needs, meet changing consumer lifestyles and plumb new purchasing power. To us, the choice is clear.