United States Senate
Committee on Agriculture
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Legislative Responses to the Dairy Crisis:
Reforming the Pricing Structure

Oral Testimony of
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Thank you for giving me the opportunity to testify today on behalf of Upstate Niagara Cooperative, and for your tireless work and support of our dairy industry, especially through these difficult times.

My name is Kim Pickard-Dudley and I am Chief Dairy Economist at Upstate Niagara, a dairy cooperative made up of 400 dairy farm families who market about 1.5 billion pounds of milk annually, and who own and operate four dairy plants in Western New York that employ about 1,000 people in Rochester, Buffalo and Batavia.

In my role as Chief Dairy Economist, I have direct access, direct responsibilities, and direct involvement with our dairy farmer members, with our commercial operations and sales staff, as well as with our commercial customers. I interact with all of these stakeholders on any and all issues relating to milk pricing, including price forecasts and risk management strategies. I also interact regularly with other dairy economists on Federal Order and dairy pricing and other policy issues.

My full testimony is set forth in my written testimony. In my oral remarks, I will focus on actions that the Senate can take to improve the U.S. dairy industry, discussing primarily changes in the Federal Milk Marketing Order System (which I will refer to as the "Federal Orders"). Since Upstate Niagara is owned by dairy farmers who operate dairy plants, we are well suited to seek real world solutions for all stakeholders in the dairy industry—from dairy farm families to processors to retailers to consumers.

We strongly believe that while there are some changes that need to occur in the Federal Orders, it is essential not to overlook the many benefits that the Orders provide to all dairy industry stakeholders. Federal Orders provide a regulatory framework in which the industry has functioned for decades, while serving consumers with a broad array of delicious, wholesome, and safe dairy products. Federal Orders also help to maintain a system of orderly marketing by establishing minimum prices that processors pay, and blend prices that farmers receive for their milk. For farmers, the blend price is a fair way to spread the benefits and burdens of supplying milk to dairy plants.

Right now, the dairy industry is in crisis. However, it would be wrong to assign the blame for the current dairy crisis to the Federal Orders. Rather, this crisis is the result of the greatest financial and economic collapse since the Great Depression which in turn led to a collapse in demand for dairy products internationally and, to a lesser extent, domestically.

The dreadfully low milk prices announced by the Federal Orders have been the messenger of this bad news. So we should not kill the messenger when, in fact, the grim message behind the terribly low milk prices spells out this stark reality – demand for dairy products has collapsed and, therefore, painful reductions in the supply of milk must occur.

We do, however, have suggestions for how the messenger can more appropriately deliver the message – so that farmers, processors, retailers and consumers aren't whipsawed every time a change in market conditions occurs.

Our suggestions deal with **improving price discovery**.

We believe that the core of the price discovery problem is this: on the Chicago Mercantile Exchange, only a scant amount of product is bought and sold by a scant number of buyers and sellers. This very small, seemingly insignificant sample has huge economic significance because it is the basis of all Federal Order pricing. In other words, it is this small quantity of milk that is used to set pricing for all federally regulated processors and that ultimately drives the price that dairy farmers receive for their milk.

What we see as being a solution to the pricing structure dilemma, therefore, is to find ways to use a broader basket of price discovery tools – that are more reflective of the current supply/demand situation – to be the basis of the price that processors pay and dairy farmers receive for their milk.

For example, we should use additional products in the pricing formulas, such as mozzarella cheese.

We should use additional markets in the pricing formulas, such as the futures markets.

We should use actual prices paid for dairy products in the pricing formulas, such as pricing surveys.

And lastly, we should use gauges of input costs in the pricing formulas, by using indices, such as the CPI and others that track certain costs, such as corn and energy.

Each factor would be assigned an appropriate weighting; for example, 20% cash spot prices, 20% futures markets, 30% pricing surveys, and 30% selected indices.

Such a basket of price discovery tools has several benefits.

First, by using a variety of price discovery tools from a variety of sources – cash markets, futures markets, pricing surveys and selected indices, you inherently improve the integrity of the marketplace by (1) adding liquidity to the market, and (2) smoothing out random, extreme (and perhaps unwarranted) price fluctuations.

Second, by using a variety of price discovery tools from a variety of sources, it allows the industry to learn the advantages and disadvantages of each factor gradually.   The benefit of this gradual learning curve in developing price discovery tools is best seen from the unintended adverse consequences that have developed since the last major change to price discovery about 10 years ago.

At that time, the Federal Orders started using a system called "end product pricing" to determine minimum prices. The USDA's decision was based on much learned testimony and analysis by some of the most experienced dairy economists in the country. **Nevertheless, real world experience has revealed a number of harmful drawbacks to both producers and processors as a result of end product pricing.**

I've spelled out these harmful drawbacks resulting from end product pricing in my written testimony – namely, the problems of make allowances – but suffice it to say – these drawbacks have created huge problems for processors in recovering real costs from the marketplace as well as blatant unfairness to producers.

To summarize, it is my view that a necessary first step in reforming the pricing structure of the Federal Orders – is to fix the flawed system of price discovery. This system has created huge problems for processors, blatant unfairness to producers, and has fostered extreme price volatility. Twenty dollar milk one day and ten dollar milk the next is unhealthy and destructive for dairymen, processors, retailers, and consumers alike.

In addition to price discovery, I want to very briefly highlight a few other items relating to Federal Orders that warrant your attention.

First, USDA needs to resolve a Federal Order product classification issue that has been tied up in the hearing process now for years. **We need a decision out of USDA that will encourage the domestic production of dairy protein ingredients, such as MPCs.** We see tremendous opportunities in the marketplace for products that are rich in dairy-sourced protein and lower in calories and carbohydrates. And, we would like to see the production of such dairy protein ingredients occur domestically, rather than be imported; and, for U.S. dairy farmers to benefit from such opportunities, rather than farmers from foreign countries.

Right here in Batavia, New York, the O-AT-KA Milk Products plant has a several million dollar capital expansion project to produce such dairy protein ingredients, but, that several million dollar capital project has been on hold since the summer of 2005 awaiting a USDA decision on this unresolved issue.

Second, dairy farmers need help and support in learning how to use risk management tools, such as futures and options to protect themselves from price volatility. The federal government should sponsor pilot programs to enable dairy farmers to test certain risk management tools much the same as the federal government has long helped farmers determine whether new seeds and farming techniques may benefit them.

Again, thank you for this opportunity to appear before you. I'm glad to answer any questions that you may have.