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Presented By:

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Chairman Peterson, Vice Chairman Holden and distinguished members of the Committee, welcome and thank you for inviting the Commonwealth of Pennsylvania to be part of this important hearing to explore potential actions to strengthen our dairy industry.

On behalf of Governor Edward G. Rendell, it is my honor to testify before you today. The Governor has been a strong advocate in seeking new and innovative tools, programs and policies at the state and federal level to help our state's dairy industry address the current economic struggle as well the future of Pennsylvania agriculture's largest sector. We appreciate your interest in the dairy industry, and we look forward to working with you and the Committee to find both short-term and long-term solutions to the current financial challenges that our dairy farms face. We can not allow this moment to pass without aggressive action on dairy policy reform, pricing transparency, risk management tools, and adequate financing mechanisms. The industry simply cannot hit pause and wait until the start of Farm Bill negotiations to actively address dairy policy and price reform. We must use the time at hand to explore and experiment on some of the critical dairy issues – and then use these experiences to inform the work that we do in the next Farm Bill. In addition to looking to the future, we must also utilize every ounce of authority available to us today to have a positive impact on the farmers' margins since milk prices continue to erode.

We are very appreciative of Congress for the Dairy Loss Assistance Program and the efforts of USDA Secretary Vilsack, including the creation of the Dairy Industry Advisory Committee, the purchase of dairy products for nutrition programs and the steps taken to increase the support price. All of these actions are helpful and have provided much-needed encouragement to our dairy farm families that we value their work and we are prepared to work together to find solutions.

The last 12 to 18 months have caused considerable debate – and rightly so – about our existing U.S. dairy policy and to what extent it serves the needs of dairy farmers, milk processors and consumers. As painful as this period has been, it is important to not loose sight of what has happened to U.S. dairy production over the past 30 years: production has risen from 129 billion pounds in 1980 to 189 billion pounds in 2008. We have also enjoyed increasing exports of dairy products during this same timeframe, reaching a peak in 2008 when 11.5% of our domestic product was shipped and marketed outside of the U.S. Looking forward, the United Nations Food and Agriculture Organization has called for a 100 percent increase in food production by the year 2050, prompting the U.S. Dairy Export Council to conclude that the U.S. will have a significant opportunity to continue growing exports to help meet the increased expectation for food worldwide. This is positive news, and should help shape a U.S. strategy for dairy that sees our industry as the source for growing demand, creating the opportunity for dairy farms to incorporate additional family members, welcome the next generation of producers back to profitable operations, and grow dairy-related businesses.

Having stated the above, we know that this scenario does not occur simply because we wish it to. Today we face a crisis in our dairy industry not just of price, but of confidence - confidence in the market; confidence in the prices going back to our farmers; confidence in our ability to continue to manage viable dairy operations. The current systems used to discover prices, manage risk and protect farm income, and secure financing/bolster farm equity must be revisited before we can truly move past this crisis.

Understanding that price discovery has an important place in smoothing the peaks and valleys impacting the dairy industry, Pennsylvania developed (in cooperation with dairy economists from the Land Grant institutions in Pennsylvania, New York and Wisconsin) dairy policy recommendations in 2007 that we believe hold true today. There has been growing concern for some time that the amount of dairy product being bought and sold on the Chicago Mercantile Exchange (CME) is a very small sample in relationship to the overall quantity of milk products produced in the U.S. This “small sample” has huge economic implications for dairy farmers, as it effectively sets the price they receive for their milk. This is an issue that deserves immediate attention.

We must improve the systems of price discovery; the dairy industry would benefit from a reliable and transparent method of price discovery for the commodities produced. Many individuals in the room today worked hard to get language in the 2008 Farm Bill that mandates greater transparency. We need to have the reporting provision activated so we can have an informed discussion about the value of milk – which is required before we can honestly redesign the milk pricing system. Presently, the CME market for cheese and butter is thinly traded and is the market of last resort for both buyers and sellers. Yet these are the transactions that send the signal to USDA’s National Agricultural Statistics Service (NASS) for prices of dairy products, which the Federal Milk Marketing Order system depends on for market prices of dairy commodities. The challenge in this system is that the NASS survey creates a lag in pricing information (typically one to two weeks). Understanding that the NASS work is the foundation for the dairy pricing system, the NASS survey must be improved. This should include the elimination of lag time, applying the survey to all dairy products sold (including inventories in cold storage facilities), and mandatory daily reporting as required by other protein commodities. We believe this change – which could be implemented by NASS or USDA’s Agricultural Marketing Service (AMS) – would represent a major step forward by the industry and would require a minimal investment.

We would also like to improve the integrity of the marketplace – again addressing the crisis of confidence – by creating an alternative to the CME or using a collection of price discovery tools that would more accurately reflect current market conditions of supply and demand. These tools could include the futures market prices, reportings of actual prices paid from mandatory pricing surveys, and Consumer Price Index (CPI) numbers which reflect the costs of corn, energy and other input costs realized by farmers. Each factor would be assigned an appropriate weighting and would have numerous benefits to dairy farmers. By using a collection of discovery tools for price such as cash and futures markets, pricing surveys and input cost calculations, the integrity of the marketplace is improved and extreme price fluctuations are abated.

In addition to addressing what we believe is a flawed pricing system, we must use this time to create a new outlook on income protection by farmers and allied industry partners. The most important recommendation I can share here today is that we borrow a lesson from the crop side of our business, where risk management has been used to help protect the income of farmers and transfer this learning to the dairy industry. The time is right to make workable, meaningful and affordable voluntary dairy risk management products available to producers.

August of 2008 saw the launch of a new risk management program for dairy producers. Livestock Gross Margin for Dairy, or LGM Dairy, is a federally reinsured dairy insurance program now included with USDA's crop insurance offerings. The program provides protection against unexpected declines in gross margins on targeted quantities of milk, without forfeiting increased profits. The program is based on milk income over feed costs, which are termed the "gross margin." The insurance policy covers the difference between the expected gross margin (insurance guarantee) and the actual gross margin for the producer's selected months, based on a targeted amount of milk. Futures prices from the CME and Chicago Board of Trade (CBOT) are used to determine the values of Class III milk, corn and soybean meal. Futures prices result in uniform commodity prices for all producers, however the program offers flexibility in the margin insured by individual producers and the months covered by the policy. There is a maximum enrollment limit of 240,000 hundredweights of milk per year.

There is no doubt that a risk management tool for dairy producers is required. This option is available for all other major agricultural commodities, and risk management has been used quite effectively in Pennsylvania since the state was severely impacted by a disastrous drought in 1999. As we have promoted LGM Dairy in Pennsylvania and worked with the crop insurance industry and producers alike to encourage participation, we have received valuable feedback on how to speed the adoption of this critical tool. We would request your support for flexibility for the producers to pay the premium costs for policies incrementally, versus one flat, up-front fee, which would better reflect the standard business operations of the dairy industry. As most dairy farmers operate on a cash flow basis, this change would be a significant help in aligning this product with standard financial management protocols. An extension of the sales closing period for LGM Dairy would also encourage more producers to take advantage of this new risk management option.

We believe that LGM Dairy has great potential to help dairy producers better manage their risk, but at this point it is cost-prohibitive and needs premium subsidy. In addition, since this is a new concept for the industry, we must have an aggressive and sustained education campaign – for producers as well as the insurance industry.

While we have provided the insight we have gleaned throughout the process of helping to launch LGM Dairy, we know that this is just one tool available to the dairy industry. Perhaps there are other approaches to managing risk. Now is the time to experiment and learn, allowing us to take the best ideas forward in the 2012 Farm Bill.

The support of the Committee is requested to address the need for risk management in the dairy industry, including assistance with funding producer-paid premiums and industry education.

In Pennsylvania, many of our dairy producers have gone months without a paycheck. This diminished income has had a severe impact on cash-flow and farm equity. Credit, equity loss, and existing banking and UDSA Farm Service Agency (FSA) regulations require attention at this time to provide producers with a bridge to a better year. There are two key terms to keep in mind when discussing the current agricultural credit situation – risk and uncertainty.

We increasingly hear of producers seeking loans from the USDA Farm Service Agency, and we have shared recommendations with Secretary Vilsack on options to extend the support provided by the state FSA teams. We know that many of the producers turning to FSA have not worked with this group before, raising both the number of borrowers and the dollars being borrowed. According to the Pennsylvania FSA office, the loan portfolio for the state has grown from $350 million less than a year ago to more than $425 million today – and 65% of this portfolio is tied to the dairy industry. While we deeply appreciate this support and the breathing room the FSA funds provide to producers, we worry that this rate of increase is not sustainable and that FSA funds may be depleted, compounding existing credit issues.

Dairy producers are not unaccustomed to a fluctuating market or the associated spikes and drops reflected in the wholesale price of milk. Historically, producers have been able to manage these cycles by implementing best management practices, developing sound business plans and establishing cost-saving measures in their operations to create a reserve in good times and counteract decreases in cash flow when milk prices drop. This dynamic has prompted producers to develop strong relationships with their lenders and creditors to manage debt, and has helped highlight dairy farmers among the most reliable borrows in a lender's portfolio.

The challenge, then, is not fiscal management. It is – to a certain extent – the nature of the industry itself. Dairies are not like many other businesses, as they cannot shut down a production line during downturns. Milking must continue, multiple times each and every day. The option to sell cows does not hold a strong appeal, as this further reduces equity and cash flow on the farm. Additionally, cow prices track with the movement of the market, meaning producers receive lower prices for animals they sell during downturns in the market and then must pay increased prices as they look to increase their herd size and production levels – a lose/lose proposition in any industry.

Agricultural lenders are keenly aware of these unique market situations and experience has shown that this group works diligently to help their customers through downturns. Despite solid business plans and sound management to build financial cushions to support the dairy during periods of low prices, this most recent downtown was far deeper and much longer than we could have predicted. The overall loss of cash-flow, coupled with losses in real estate values has diminished or nearly eliminated equity on some of our most progressive and forward-looking farms.

History has shown us that another downturn will occur. Should this take place in the near-term, lenders will be forced to assess how many of their customers will have the cash reserves required to survive, further exacerbating the risk being assumed by both lenders and borrowers – and greatly impacting the available credit that will be required to sustain the dairy industry.

We do not live or work in a vacuum. Collapses in the real estate market coupled with those in the larger lending sector have had an impact on the dairy industry. Today, lenders are under more scrutiny than ever by stockholders as well as regulators. Even in instances where lenders are willing to extend forbearance to dairy producer clients, regulations are having an impact that hampers this action and, in some instances, prevents it. Post-TARP changes in how troubled assets (those accounts greater than 90 days past due) are accounted for on lenders' books have forced a higher standard of risk assessment on loans and has resulted in the reduction of availability of credit for many existing and new borrowers.

Perhaps the best way to describe the effects of these confluences of trends is through examples of dairies in Pennsylvania. A dairy farm in Lancaster County provides a great illustration: Approximately three years ago, a progressive 150 cow operation with an updated business plan and sound best management practices decided to bring their two children into the farm business as partners and managers. These two new partners each had families of their own and were excited to represent the next generation making a living on the home farm.

The business plan was revisited and the decision was made to add an additional 125 cows, raising the herd total to 275. This expansion required expanded manure and feed storage, as well as the rental of an extra 250 acres to meet feed and best management practice needs.

At the time, milk prices were strong and cow costs were in the $1,400/cow range – meaning their planned herd expansion had a price tag of $175,000. Their additional infrastructure needs were calculated at $2,000/cow, resulting in a $250,000 expense. At the time expected income over feed costs on the farm would have provided for a milk margin on $13.00/hundredweight (cwt). Based on this information, expected additional debt load, and projected energy and family living costs, it was determined that the business plan showed sufficient equity and cash flow to make this plan a reality.

Fast forward to 2009 – just two years into the additional debt load and expenses – and the income over feed costs milk margin that was at $13.00/cwt had plummeted to $6.50/cwt, about 50 percent of what had been projected. Coupled with increased energy and family living costs, the farm was struggling to keep up with expenses.

As this milk price drama unfolded, the real estate crisis drove down land values, reducing the equity built up over generations. In addition, cow prices were declining, meaning the herd the family had on hand was worth less – regardless of milk production. The farm's debt now exceeded existing equity.

The family was aware and took advantage of programs designed to assist them, restructuring operating expenses to a lower percentage term loan through the USDA Farm Service Agency and working with their other lenders who held the infrastructure debt.

While this family was able to survive the downturn in 2009, they are still facing its challenges and realities. Cash reserves are low and cash flow is only now in 2010 starting to meet their operating expense needs. They have additional term debt through the restructuring of 2009 operating expenses, and equity on the farm – while increasing – will likely not allow for further infrastructure investments or emergency actions should a building or equipment need replacing. Consequently, their operating expense lines of credit with their lenders have been reduced, creating more risk and uncertainty as the children of the new farm partners evaluate the potential for them to continue on this family operation when they complete college. This story is not unique to the family in question and is, in fact, playing out on numerous farms in Pennsylvania – with much more dire results in many cases.

Assistance for agriculture and especially the dairy industry exists at many levels of government. However, we must not become complacent in what exists and we must look at bolstering existing programs and exploring new ways to maintain a vibrant diary industry. Most of the dairies that have survived to-date will find it difficult to say the least to make it through another downturn, especially one as protracted as the crisis we are still working through.

I share this example to emphasize the important role our financial institutions play in supporting the dairy industry. Agriculture is a business without walls, but it is every bit a business and we must take strides to ensure that our farmers have access to the capital and resources needed to survive today so they can thrive tomorrow.

While we are exploring all options with Congress and the USDA, let me assure you we are doing the same right here in Pennsylvania. We are fortunate to be one of a small number of states that have a state pricing mechanism to assist dairy farmers. The Milk Marketing Law was first enacted in 1937. The Pennsylvania Milk Marketing Board (PMMB) has exercised its authority under the statue in various ways since then in an effort to be responsive to changing market conditions. The Governor and the Department continue to work with the Board to ensure farmers are receiving the full benefit of the over-order premium, as we know well the value of this additional income.

I have said often that you never want to waste a crisis. We didn’t want this challenge, but there is no better time for good thinking than when you are under fire. It is imperative that we listen, learn and lead during this time of crisis. We do this through sessions like today’s hearing where we can engage in discussions about the industry and its future. We also meet this prompt by evaluating the tools at our disposal to support the industry and investigating new ways to price our products, protect farm-level margins and income, and secure financial resources for dairy operations.

Our actions here today do far more than bolster the leading sector of Pennsylvania agriculture. Our voices, our actions and our leadership recognize that the dairy industry is an important part of our nation’s heritage – and set the path for this industry to be a vibrant part of our future.

Having the right state and federal dairy policies in place will be critical to improving farm income, capturing international markets and encouraging investments at all levels of the industry – from the farms to the processors. For these reasons, I want to thank you for your continued good work and willingness to challenge all of us to think creatively about possible solutions both short- and long-term. It is our goal to see from this crisis a dairy industry that is stronger, both here in the U.S. and around the world.

Thank you.