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House Committee on Agriculture

Statement by

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Before the Subcommittee on Livestock, Dairy, and Poultry,

Committee on Agriculture, U.S. House of Representatives

July 14, 2009

Chairman Scott, Ranking Member Neugebauer, and distinguished members of the Subcommittee, I appreciate the opportunity to discuss the dairy market and programs delivered by my mission area in the U.S. Department Agriculture (USDA). As Under Secretary for Farm and Foreign Agricultural Services (FFAS), I oversee three agencies: the Farm Service Agency (FSA), the Foreign Agricultural Service (FAS), and the Risk Management Agency (RMA). I would like to take this opportunity to provide you an update on the dairy market situation, our forecasts for the dairy market through the end of the calendar year, and my mission area's response to the sharp downturn in milk and dairy products markets. I will also provide information on the activities of our sister agencies, the Food and Nutrition Service and the Agricultural Marketing Service.

THE DAIRY MARKET SITUATION

The dairy industry has been one of the hardest hit sectors in agriculture in the past year, with producers caught between high feed and other costs and depressed output prices. We have heard many personal stories from dairy producers who are in desperate financial straits. The Secretary's office alone has received hundreds of letters and calls from dairy producers who are in need of help. The Secretary has personally discussed with numerous dairy farmers the poor dairy situation and listened as they related the fears they have about the loss of their way of life. He has traveled to many states to hear directly from dairy farmers, implemented a series of policies to assist these producers, and made efforts to communicate what help is available from USDA.

Prices, Input Costs, and Income

I'd like to provide a bit of an economic backdrop to the dramatic downturn in the dairy sector. The monthly all-milk price peaked in the July-September period of 2007 at a record $21.70 per hundredweight (cwt) and averaged a record high of $19.21 for all of 2007. In 2008, the farm-level milk prices remained strong with the all-milk price averaging $18.41 per cwt, the second highest on record. However, average feed costs increased about 35 percent in 2008, and energy costs increased by 30 percent.

This spring, producers were receiving less than $12 per cwt. Meanwhile, the milk/feed price ratio, a measure of the profitability of producing milk, was the lowest in over 25 years in the first and second quarters of 2009. Feed costs, which traditionally have comprised about one-half of variable operating costs, are expected to decline about 15 percent in calendar 2009. At the same time, USDA projects that the all-milk price will decline by 34 percent in calendar 2009, to an average of $12.15 per cwt—the lowest average annual price received by farmers for milk since 1979.

Cash receipts from milk marketings jumped to a record $35.5 billion in 2007, dropping slightly to $34.8 billion in 2008. While cash receipts remained relatively steady in 2008, USDA's Economic Research Service (ERS) reported this past December that high feed costs reduced net cash income for dairy producers by an estimated 40 percent. For 2009, cash receipts are expected to fall by over one-third to $23 billion. With feed costs now accounting for 70 to 80 percent of variable operating costs in recent months, dairy producers are facing financial hardship.

Further, ERS data indicate that dairy farms are among the most highly leveraged in U.S. agriculture: about 70 percent of dairy farms use debt, compared to about 30 percent of beef and 50 percent of cash grain farms. Some of the largest dairy farms are the most heavily indebted. Across all sectors in agriculture, dairy ranks third in the average debt to asset ratio, behind poultry and hogs. The financial crisis has made the credit needs of dairy producers all the more pressing.

Herd Size

In response to record high milk prices and above average returns in 2007 and 2008, the U.S. dairy sector expanded rapidly through the second quarter of 2008 to accommodate growing domestic and foreign demand for dairy products. Cow numbers increased from 9.13 million at the end of 2006 to a peak of 9.34 million in July 2008. Cow numbers remained steady during the second half of 2008 despite the deteriorating market outlook, as above average returns in previous months led farmers to bring additional heifers into the breeding herd.

Producers are responding to the current depressed market situation by reducing herd numbers. Cow numbers dropped below a year ago in March 2009 and are expected to average 145,000 lower in 2009 than in 2008. Much of the recent reduction in cow numbers has come in the far western States, where producers tend to have lower overall costs but higher feed costs per cwt of milk produced because they are farthest from major grain producing areas. ERS publishes milk cost of production estimates by state. As an example, for May 2009, California costs for feed were $12.19 per cwt of milk produced. In contrast, the California all-milk price reported by the National Agricultural Statistics Service (NASS) for May was $10.53 per cwt. In a relative sense, New York and Wisconsin fared somewhat better. In New York, feed costs were $10.67 per cwt, while the all-milk price was $11.90. In Wisconsin, feed costs in May were $8.38 per cwt, while the all-milk price there was $11.60.

Demand

Dairy product exports have declined sharply in recent months after reaching a record $4 billion in FY 2008. In FY 2009, the value of U.S. dairy product exports is forecast to drop to $2.3 billion. Cheese exports in April 2009 were down nearly one-half from their April 2008 peak. Butter exports have fallen more than 80 percent from their August 2008 peak, and nonfat dry milk/skim milk powder exports are off more than 70 percent from their May-June 2008 peak.

There are many factors contributing to lower demand and the decline in farm-level milk prices. Drought in New Zealand and Australia contributed to record high international prices for dairy products in 2007 and 2008, boosting U.S. dairy product exports. More normal weather has returned to both of those countries leading to increased milk production globally. The global recession, the melamine scare in China, European Union export subsidies, and increases in the value of the dollar have also lowered the demand for U.S. dairy products in world markets. At home, the economic crisis and, until recently, record high retail dairy product prices, have curtailed domestic demand for dairy products.

Outlook for 2010

Milk production is forecast to fall by 1.3 percent in 2009 and an additional 0.6 percent in 2010. Cow numbers are forecast to drop to 8.89 million by December 2010. Reduced

production, an improved economy, and lower retail dairy product prices are expected to lead to a gradual increase in milk prices and improved returns later this year and into next year. USDA is currently forecasting the all-milk price to average $11.60 per cwt in the third quarter and $13.10 in the fourth quarter. For all of 2010, we are projecting an all-milk price of $15.60.

USDA SAFETY NET PROGRAMS

USDA is currently operating four safety net programs that provide assistance to help producers through this difficult time.

Dairy Product Price Support Program

I'd like to first discuss the Dairy Product Price Support Program (DPPSP), which helps support prices and farm incomes. The Food, Conservation, and Energy Act of 2008, commonly referred to as the 2008 Farm Bill, requires the Secretary to operate the DPPSP in a fundamentally different manner than under the 2002 Farm Bill. Under the new Farm Bill, the Commodity Credit Corporation (CCC) now supports the prices of cheddar cheese, butter, and nonfat dry milk by purchasing these products per minimum price levels for each commodity that are set in the 2008 Farm Bill. In contrast, the 2002 Farm Bill required the Secretary to support the price of milk at $9.90 per cwt by purchasing

butter, cheese, and nonfat dry milk. To fulfill this mandate, the CCC established purchase prices for butter, cheddar cheese, and nonfat dry milk.

From October 1, 2008 to date, USDA has purchased 272 million pounds of nonfat dry milk and 4.6 million pounds of butter under this program thus far. During the first six months of 2009, USDA has purchased 170 million pounds of nonfat dry milk, the equivalent of about 30 percent of production. USDA expects CCC to be offered an additional 40 million pounds of nonfat dry milk during the remainder of calendar 2009. We have not purchased any cheese at this time. The wholesale prices for cheddar cheese and nonfat dry milk are near support levels of $1.13 per pound (40-pound blocks) and $0.80 per pound, respectively. The wholesale price of butter is currently about $0.15 per pound above the CCC purchase price of $1.05.

As many of you are aware, the Secretary announced on March 26, 2009 that approximately 200 million pounds of nonfat dry milk would be further processed or bartered for dairy products for use in domestic and international feeding programs. The nonfat dry milk is being further processed or bartered into value-added products, such as instantized nonfat dry milk, ultra high temperature milk, cheese, and ready-to-eat milk-based soups. To date, the Food and Nutrition Service (FNS) has received orders for approximately 30 million pounds of ultra high temperature milk for the National School Lunch Program and the Emergency Food Assistance Program, and has bartered for over 22 million pounds of assorted cheeses. These foods will go a long way towards feeding

American school children and alleviating the difficulties of those affected by the economic crisis.

This is just one example of USDA fulfilling its dual-mission of supporting American agriculture—in this case, the dairy market—through market support programs, and working to alleviate hunger by distributing those same dairy products through domestic and international nutrition assistance programs. In fact, in fiscal year 2008, approximately $9.6 billion in USDA funds were spent on dairy products ultimately used in the United States, through a combination of purchases made through, or used for, programs such as the Supplemental Nutrition Assistance Program (formerly the Food Stamp Program), the National School Lunch Program, and the Supplemental Nutrition Assistance Program for Women, Infants and Children.

Milk Income Loss Contract Program

In order to provide assistance as quickly as possible to dairy producers, FSA published regulations re-authorizing the revised Milk Income Loss Contract (MILC) program on December 4, 2008. The 2008 Farm Bill modified and re-authorized the Milk Income Loss Contract (MILC) program which provides counter-cyclical payments to producers in times of low prices. Under the MILC program, direct payments are provided to dairy producers in all States if the monthly Class I price in Boston is below $16.94 per cwt. The 2008 Farm Bill increased the payment trigger of $16.94 during January 1, 2008 through August 31, 2012 if the National Average Dairy Feed Ration Cost exceeds $7.35

per cwt. In addition, the Farm Bill increased the annual production eligible for payment from 2.4 million pounds to 2.985 million pounds during October 1, 2008 through August 31, 2012, and increased the payment factor from 0.34 to 0.45. The Farm Service Agency (FSA) began sign-up for the new MILC program on December 22, 2008 and sign-up will continue through the program's expiration date, September 30, 2012.

Declining milk prices caused the Boston Class I price in February, 2009 to fall below $16.94, triggering MILC payments. USDA began distributing MILC payments in early April after the information needed to adjust the $16.94 trigger price for feed costs became available and the final payment rate was calculated. The MILC payment rate, including the feed cost adjuster, is set at $1.51 per cwt for milk marketed in February, $2.01 for milk marketed in March, $1.59 for milk marketed in April, and $1.47 for milk marketed in May. The MILC payment rate, unadjusted for feed costs, for milk marketed in June is $1.62 per cwt and for milk marketed in July is $1.54 per cwt. For the February through May period, the feed cost adjuster added about $0.15 per cwt, on average, to the MILC payment rate.

MILC payments are likely to continue for the next several months. If current futures price levels are realized in cash markets, MILC payments will be triggered for the months of August through November. Futures suggest that milk prices will be strong enough to avoid triggering MILC payments in December and succeeding months. As of June 30, 2009, over $450 million had been issued to dairy producers through the MILC program. During FY 2009, USDA expects to issue about $900 million in MILC payments.

Dairy Export Incentive Program

On May 22, 2009, USDA announced the reactivation of the Dairy Export Incentive Program (DEIP) with allocations for the export of 68,201 metric tons of nonfat dry milk, 21,097 metric tons of butterfat, and 3,030 metric tons of cheese. The above quantities reflect the maximum volume of dairy products the U.S. is allowed to export with subsidies consistent with the U.S.'s World Trade Organization (WTO) commitments. The DEIP, reauthorized under the 2008 Farm Bill, helps U.S. exporters meet prevailing world prices and encourages the development of international export markets in areas where U.S. dairy products are not competitive due to subsidized dairy products from other countries. As of June 30, USDA had announced awards for 20,025 metric tons of nonfat dry milk, 1,862 metric tons of butterfat, and 152 metric tons of cheese under the 2008/2009 DEIP allocations announced on May 22. Although these awards are less than the quantities that were allowed under WTO commitments, they are largely reflective of the trade opportunities that existed during the five weeks that the program was in operation for the 2008/2009 year. The Foreign Agricultural Service (FAS) awarded bonuses for 97 percent of the nonfat dry milk volume submitted by exporters.

On July 6, 2009, USDA announced the initial tranche of DEIP allocations for the July 2009-June 2010 year. This initial tranche was announced at quantity levels equivalent to the uncommitted balances remaining as of June 30, 2009. Those quantities are 48,176

metric tons of nonfat dry milk, 19,235 metric tons of butterfat and 2,878 metric tons of cheese. These quantities will count against the 2009/2010 U.S. WTO commitment levels.

As I indicated earlier, a sharp reversal has occurred in the outlook for global dairy markets. The volume of U.S exports of nonfat dry milk during the January to April 2009 period dropped by 52 percent in comparison to the same period last year. Further, the value of U.S. dairy exports in FY 2009 is expected to fall by 43 percent to $2.3 billion. In addition, there is no indication that the European Union (EU) is prepared to stop providing export subsidies for its dairy products. In fact, the EU has been progressively increasing its subsidy rates since reactivating export subsidies in January 2009.

As of June 30, total subsidy obligations for nonfat dry milk totaled just over $4 million to support 20,000 metric tons of exports under DEIP. We have calculated that to remove the same quantity from the domestic market under the Dairy Product Price Support Program would cost over $35 million. In addition, our exports will be consumed while DPPSP purchases may continue in storage. Thus, as intended, DEIP is reducing costs to the U.S. government while providing assistance to the U.S. dairy industry, which has seen its international competitiveness continue to be adversely impacted by the use of direct export subsidies by the EU.

Livestock Gross Margin-Dairy

In addition to these programs, the Livestock Gross Margin-Dairy insurance program, or LGM-Dairy, protects dairy farmers against loss of gross margin, which is the market value of milk minus feed costs. This new insurance program, which was approved by the Federal Crop Insurance Corporation board of directors in mid-2007, uses the Chicago Mercantile Exchange Group futures prices for corn, soybean meal, and class III milk to determine the expected gross margin and the actual gross margin. The indemnity paid to the policyholder at the end of the 11-month insurance period is the difference between the gross margin guarantee and the actual gross margin (if the difference is positive).

The LGM-Dairy insurance policy is customizable to fit any size farm. LGM-Dairy is also considered a bundled-option insurance, like buying both a call option to limit higher feed costs and a put option to set a floor on milk prices. The policy capacity is up to 240,000 hundred-weight per year. Dairy producers in 36 states are eligible for LGM-Dairy insurance.

THE FEDERAL MILK MARKETING ORDER SYSTEM

I would also like to talk briefly about the Federal Milk Marketing Order (FMMO) program administered by USDA's Agricultural Marketing Service. The FMMO program is not a price or income support program, but a marketing program that helps establish a

competitive balance between the many dairy farmers and the relatively few buyers of their basic commodity—raw milk. The FMMO program sets up a classified pricing system, establishes minimum class prices, and pools all revenues within the defined regional area. The primary objective of the program is to assure that fluid milk processors (bottlers) have an adequate supply at reasonable prices to meet their needs.

In 2008, about 61 percent of U.S. milk marketings were sold to handlers regulated by FMMOs, and less than 40 percent of that is used by bottlers and classified as Class I. A major milk market outside of the Federal order system is the state of California, with its own regulatory system similar to a FMMO. Other unregulated Western States include Idaho, Montana, Nevada, Wyoming, and Utah. Like California, Montana and Nevada also have state programs.

It has been suggested that the FMMO program has the authority (specifically 7 U.S.C. Section 608c (18)) to raise minimum milk prices when feed prices rise, regardless of other factors. FMMOs cannot set minimum prices and have above the relative market value of the products of milk. FMMOs have no mechanism to provide additional dollars to handlers above those received from the market in order to pay farmers more than the minimum market value of milk. Thus, raising minimum milk prices above market-justified levels would likely result in fluid milk processors taking less milk or reducing over-order premiums. It would also result in manufacturing milk plants withdrawing from FMMO pools to avoid paying prices they cannot recoup from the marketplace.

Section 608c (18) has long been viewed by the courts as the procedure by which the Secretary establishes and adjusts minimum prices. Through a public hearing, the Secretary evaluates the marketing conditions in an area and considers the price of feeds, the available supply of feeds, and other economic conditions that affect the market supply and demand for milk and its products in the marketing area. Based upon these factors, the Secretary sets milk prices that are reflective of all the economic inputs to ensure a sufficient supply of milk.

MOVING INTO THE FUTURE

I recognize the decisions that we make in Washington affect the livelihood of America's farmers and ranchers and we are committed to ensuring that we work together to help meet the needs of U.S. dairy producers. As I indicated earlier in my remarks, the plight of dairy producers is very serious.

I appreciate the opportunity to testify before this Subcommittee today, and I look forward to working with you, Mr. Chairman, Mr. Ranking Member, and all the members of this Subcommittee as we continue our hard work to ensure that USDA is responsive to the needs of the dairy sector. This concludes my statement. I will be glad to answer questions you may have.