Testimony of

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Statement by
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Chairman Leahy, Ranking Member Sessions, and distinguished members of the Committee, I appreciate the opportunity to discuss the current situation in the dairy industry. I would like to take this opportunity to provide you with an update on the dairy market situation, our forecasts for the dairy market through next year, and the Department's response to the sharp downturn in milk and dairy product markets.

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. The Secretary has personally discussed with numerous farmers the dairy market 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.

Farm 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, as drought in New Zealand and Australia lowered milk production in those two major dairy product exporting countries and strong global economic growth boosted world dairy product prices and the value of U.S. dairy product exports to record levels. 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 and summer, producers were receiving less than $12 per cwt. The milk/feed price ratio, a measure of the profitability of producing milk, was the lowest in over 25 years during the first half of 2009. Feed costs, which traditionally have comprised about one-third to 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.

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 (EU) 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.

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) reports that high feed prices caused net cash income for dairy producers to fall by an estimated 21 percent between 2007 and 2008 - from $192,000 per farm in 2007 to just over $152,000 per farm in 2008. For 2009, net cash income for dairy producers is expected to plummet to $9,200 per farm - a drop of 94 percent relative to 2008.
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 herd expanded 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 125,000 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 and tend to purchase a larger percentage of their feed.

ERS publishes milk cost of production estimates by state. As an example, for July 2009, California costs for feed were $15.42 per cwt of milk produced. In contrast, the California all-milk price reported by the National Agricultural Statistics Service (NASS) for July was $10.20 per cwt. In a relative sense, New York and Wisconsin fared somewhat better. In New York, feed costs were $11.63 per cwt, while the all-milk price was $11.70. In Wisconsin, feed costs in July were $9.19 per cwt, while the all-milk price there was $11.40.

Retail Dairy Product Prices

Retail dairy product prices tend to follow movements in farm-level prices over time. However, movements in retail dairy product prices do not exactly match month-to month movements in

farm-level milk prices and wholesale dairy product prices due to changes in the costs of processing and retailing dairy products and the pricing behavior of individual food retailers. Furthermore, the percentage decline in farm level milk prices is generally much larger than the percentage drop in retail milk and dairy product prices, because the cost of processing and retailing milk and dairy products tends to move with changes in wage rate, energy prices, and other manufacturing and retail costs independent of movements in farm level prices. For example, if the farm price represents one-third and processing, transportation, packaging, and retailing represents two-thirds of the cost of milk at retail, a one-third drop in the farm-level price of milk if fully passed on to consumers would lead to a 10-percent drop in the retail price of milk. Of course, some retailers may to choose to reduce the retail price of milk in their retail establishments or reduce prices of other items when farm-level milk prices fall to lure customers into their retail outlets.

The Consumer Price Index (CPI) for dairy products as reported by the Bureau of Labor Statistics peaked in August 2008. Since August of last year, the CPI for dairy products has gradually declined and in July was down 10 percent below the peak reached 11 months earlier. Over that same period 11 month period from August 2008 through July 2009, the CPI for fluid milk fell by 17 percent and the CPI for cheese and related products dropped by 10 percent, while the CPI for ice cream and related products was down less than 1 percent. The margin between the retail price of fluid milk as reported by BLS and the price fluid milk processors paid for milk dropped between August 2008 and July 2009 and in July 2009 the margin between the retail prices and the price paid for milk by processors nationally was nearly the same as in November 2007 when farm-level milk prices reached their peak.

Outlook for 2010

Milk production is forecast to fall by 0.8 percent in 2009 and an additional 0.9 percent in 2010. Cow numbers are forecast to drop to 8.9 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 $11.80 per cwt in the third quarter and $12.90 in the fourth quarter. For all of 2010, we are projecting an all-milk price of $15.08.

ACTIONS TAKEN BY USDA

USDA has taken numerous actions to help producers through this difficult time. In August 2009, Secretary Vilsack announced that USDA is undertaking unprecedented steps to use our administrative flexibility to provide relief to struggling individuals and businesses who have been hit by worsening economic conditions. A key area in this regard is credit. So far in 2009, the Farm Service Agency (FSA) has provided over 1,100 direct loans to dairy producers totaling approximately $70 million. We are also extending loan repayment terms for new loans and notifying FSA dairy borrowers of loan servicing options, such as a deferral of payments or rescheduling of their repayment terms.

On March 13, 2009, FSA issued a notice which contained guidance on assisting dairy producers with their credit needs. It announced that FSA is releasing milk proceeds for essential family living and farm operating expenses and notified borrowers of servicing options that may be

considered by FSA on a case-by-case basis, including extending repayment terms for annual operating loans for dairy farmers, rescheduling, consolidation, reamortization, and deferral for 1 to 5 years. We have also contacted guaranteed lenders to discuss FSA policies for dairy loans and remind them of loan servicing options available under the Guaranteed Loan Program that may be considered for certain producers.

USDA DAIRY PROGRAMS

USDA is also operating four key programs to support milk prices and the incomes of dairy producers. These programs include the Dairy Product Price Support Program, the Milk Income Loss Contract, the Dairy Export Incentive Program, and the Livestock Gross Margin-Dairy insurance program.

Dairy Product Price Support Program

The Dairy Product Price Support Program (DPPSP) supports milk prices and the incomes of dairy producers by establishing purchase prices for butter, cheese, and nonfat dry milk (NDM). As announced on July 31, 2009, USDA has increased the amount paid for dairy products under the DPPSP. These purchase price increases, which are in place from August 2009 through October 2009, increase the price paid for nonfat dry milk from $0.80 per pound to $0.92 per pound, the price paid for cheddar in 40-pound blocks from $1.13 per pound to $1.31 per pound, and the price of cheddar cheese in 500-pound barrels from $1.10 per pound to $1.28 per pound.

Cheese and nonfat dry milk (NDM) prices increased after the July 31 announcement, in part due to the impact of USDA's action and in part due to expected tightening of the market this fall. The August Class III (milk used for cheese production) and Class IV (milk used for butter and NDM production) prices were the highest of any month during 2009 and the preliminary all-milk price for the month of August was $0.50 per hundredweight (cwt) higher than July, at $11.80.

For dairy products, the wholesale prices for cheddar cheese and nonfat dry milk are now at or below the current support levels. The wholesale price of butter is currently about $0.10 per pound above the CCC purchase price of $1.05.

From October 1, 2008 to date, USDA has purchased more than 270 million pounds of nonfat dry milk and 4.6 million pounds of butter under this program, much of it during late 2008 and the first half of 2009. 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, USDA has bartered for approximately 68 million pounds of ultra high temperature milk and over 22 million pounds of assorted cheeses for the NSLP and EFAP. In addition, at least 1 million pounds of NDM will be sold on a competitive bid basis for the production of casein.

USDA is also working with the Department of State to provide foreign assistance. This assistance includes about 500,000 pounds for use in the McGovern-Dole International Food for

Education and Child Nutrition Program; and about 1 million pounds for use by the U.S. Agency for International Development, based on anticipated requests from the State Department.

Milk Income Loss Contract Program

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 or high feed costs. In order to provide assistance as quickly as possible to dairy producers, FSA published regulations re-authorizing the revised MILC program on December 4, 2008. 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 increases 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. 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, was 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, $1.47 for milk marketed in May, $1.84 for June marketings, and $1.54 for July marketings. For the February through June period, the feed cost adjuster added about $0.16 per cwt, on average, to the MILC payment rate. For July, the National Average Dairy Feed Ration Cost dropped below $7.35 per cwt. resulting in no adjustment for feed costs in the MILC payment rate.

As of September 8, approximately $700 million has been paid to producers under the MILC program this year. MILC payments are likely to continue for the next several months, although we expect the payment rate to decline given the projected increase in market prices this fall. If current USDA projections for price levels are realized, MILC payments will be triggered for the rest of calendar 2009. For FY 2009, USDA expects to issue about $750 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. These quantities reflect the maximum volume of dairy products the U.S. is allowed to export with subsidies consistent with the U.S. World Trade Organization (WTO) commitments on a July through June year. On July 6, 2009, USDA announced that the uncommitted balances still available from the May allocation would be made available and form the initial allocations under the July 2009 through June 2010 year. 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. 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 July 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. The volume of U.S exports of nonfat dry milk during the January to July 2009 period dropped by 48 percent in comparison to the same period last year. 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 September 4, 2009, total subsidy obligations for nonfat dry milk totaled just over $7 million to support more than 37,000 metric tons of exports under DEIP. We have calculated that to remove the same quantity from the domestic market under the DPPSP would cost over $65 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 the above 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 can be customized to fit any size farm. LGM-Dairy is also considered a bundled-option insurance--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. In March, 2009, the Federal Crop Insurance Board of Directors approved expansion of the sales period to allow more time for LGM-Dairy sales and other enhancements to make LGM-Dairy more producer-friendly. Currently, 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 a defined regional area. The primary objective of the program is to

assure that fluid milk processors (bottlers) have an adequate supply of milk to meet the needs of consumers and farmers receive a fair price for their milk.

In 2008, about 61 percent of U.S. milk marketings were sold to handlers regulated by FMMOs, and less than 40 percent of the milk sold to regulated handlers was 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 market factors. FMMOs cannot set minimum prices 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 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 to producers that exceed the value of dairy products sold less processing and other operating costs.

DAIRY INDUSTRY ADVISORY COMMITTEE

Over the past three years, we have seen farm-level milk prices decline from relatively high levels in 2007 and 2008 to the lowest levels in 25 years in 2009. This boom and bust cycle in farm-level milk prices has repeated itself several times over the past three decades. The price and income volatility in the dairy sector calls for creative thinking across all the various components of the dairy sector regarding longer-term solutions. To jumpstart thinking about longer-term solutions, on August 25, 2009, USDA announced that nominations would be accepted to form a new Dairy Industry Advisory Committee. The Secretary of Agriculture will appoint up to 15 representatives from the dairy industry to serve in an advisory capacity. These appointed representatives will include: producers and producer organizations, processors and processor organizations, handlers, consumers, academia, retailers, and state agencies involved in organic and non-organic dairy at the local, regional, national and international levels. To clarify, the advisory board is not the FMMO Review Commission established in the Food, Conservation and Energy Act of 2008, although it is likely to consider issues related to federal milk marketing orders.

Nominations must be received on, or before, September 28, 2009. The Advisory Committee will review farm milk price volatility and dairy farmer profitability and provide suggestions and ideas to the Secretary on how USDA can best address these issues to meet the dairy industry's needs.

This concludes my testimony. I will be glad to answer questions you may have.