STATEMENT OF

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HOUSE AGRICULTURE AND RURAL AFFAIRS COMMITTEE

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In the decade following World War I, the dairy industry enjoyed an era of prosperity – strong foreign and domestic demand supported heavy production and adequate prices. With the onset of the depression, however, widespread unemployment and reduced incomes severely eroded much of this demand while production and supply continued at relatively constant levels. Just as we are seeing today, the usual result of such economic imbalance ensued then: producer prices were forced into decline. In the unregulated environment of the depression era, destructive price wars accompanied and contributed to the downward spiral in producer prices. The middle of the supply chain – the milk processor – naturally attempted to shift the effects to the producer, and the prevailing economic conditions and characteristics of the industry made this a simple task. The processors in a particular region were the principal outlet for nearby producers. The high cost of transporting fluid milk and the perishability of the product eliminated more distant buyers from the producer's market. With the unfavorable economic climate of weak demand combined with more than abundant supply, it is not difficult to see that the farmer had little choice but to accept the price dictated by the available processor. The alternative was dumping or spoilage of the dairy farmer's production.

Fearful that meager returns to the producer would result in the elimination of costly sanitary practices and the abandonment of many farms, both of which threatened the adequacy of a wholesome milk supply, Pennsylvania joined 22 other states and the federal government in enacting remedial legislation. An emergency one-year milk control statute was passed in 1934, extended once, and then reenacted in permanent form in 1937. It is this law, with subsequent amendments, that is implemented today as the Pennsylvania Milk Marketing Law.

Today, the Pennsylvania Milk Marketing Board administers a comprehensive milk pricing program that enhances the farm milk price while at the same time providing a fair and competitive price for consumers. The Board establishes minimum producer, wholesale, and retail prices. The minimum producer price includes a Board-mandated over-order premium on Class I milk produced, processed, and sold in Pennsylvania. The over-order premium is adjusted periodically based on evidence received at hearings held by the Board. By maintaining minimum retail and wholesale prices, destructive price wars at those levels are eliminated and there is no pressure to reduce farm prices to meet competition. The key to the program is that Pennsylvania maintains the authority to regulate all sales of milk where possession transfers within the state's borders. It is also important to keep in mind that the only transactions the Board is allowed to regulate are those that occur within our borders.

To be more specific regarding how the Board's actions affect producer prices, the over-order premium directly impacts 15% - 20% of the milk produced in Pennsylvania. Since its inception in 1988 through the end of June 2009, the direct impact of the over-order premium has resulted in Pennsylvania producers being paid an additional $476 million. The over-order premium also indirectly impacts most of the milk produced in Pennsylvania that it does not directly impact. This is because the over-order premium sets the bar that milk purchasers must meet when buying producer milk. The market for producer milk is competitive and purchasers of producer milk must pay competitive prices to attract milk to their plants. Without both the direct and indirect impacts of the over-order premium, under current conditions of relatively high raw milk supply and relatively weak demand, the price received by all Pennsylvania producers would be significantly lower. The all-milk price reported by the United States Department of Agriculture is illustrative: during 2009, Pennsylvania producers have received a higher all-milk price than the national average and have received a higher all-milk price than producers in Ohio and New York, the surrounding states for which data were available.

Many people ask why the Board-mandated over-order premium is not payable on all milk produced in Pennsylvania. There are several reasons. First, Pennsylvania produces much more milk than our citizens consume. Pennsylvania per capita milk production in 2008 was approximately 850 pounds, while per capita fluid milk consumption was approximately 190 pounds. The balance of the milk is sold for fluid consumption outside Pennsylvania or to produce cheese, butter, and milk powder. Remember, the over-order premium is payable on milk sold as a fluid beverage that is produced, processed, and sold in Pennsylvania. Since most of the milk produced in Pennsylvania is used to manufacture Class II, III, and IV products such as cheese, butter, and milk powder, with some being used as Class I beverage milk outside Pennsylvania, it is not available to be directly impacted by the Board-mandated over-order premium.

So why does the Board not mandate a premium on the other classes of milk? The cheese, butter, and powder markets are national due to the less perishable nature of those products. In a national market there are many more opportunities to acquire milk at low prices. Pennsylvania milk and the cheese, butter, and powder manufactured from it compete nationally with products manufactured all over the country. Mandating a premium inside Pennsylvania for non-Class I milk could make that milk and the products manufactured from it non-competitive in that highly competitive national market.

Similarly, the Class I over-order premium must be established with the regional fluid milk market in mind – setting the over-order premium too high would at some point encourage milk purchasers to seek a lower cost supply from non-Pennsylvania producers or would encourage retailers to seek a lower cost wholesale supply outside Pennsylvania. As a matter of fact, at the last over-order premium hearing, held back in June, a group of dairy cooperatives, which included the Greater Northeast Milk Marketing Agency, Dairylea Cooperative, the Northeast and Mideast Area Councils of Dairy Farmers of America, Land O'Lakes, and Maryland and Virginia Milk Producers testified that the over-order premium should not be increased because competitive conditions did not allow for an increase.

We know that there is some concern, and confusion, regarding the relationship between retail milk prices and the prices paid to producers. In Pennsylvania, the Milk Marketing Board establishes minimum producer, wholesale, and retail prices based on the costs incurred by a cross-section of each of those industry segments. There are three basic building blocks the Board uses to establish minimum retail prices: the Class I price received by the dairy farmer; the cost to process raw milk, put it into consumer packages, and deliver those packages to a store; and the cost to handle and sell milk to the consumer in the store. The processor and retailer costs are determined once per year at a public hearing and remain virtually unchanged throughout the remainder of the year. Some of the processor and retailer costs are subject to minor monthly updates based on increases and decreases in certain input costs, such as diesel fuel, natural gas, plastic resin, and the Consumer Price Index.. The over-order premium is also updated monthly based on changes in diesel fuel costs. Because the processor and retailer costs used to determine minimum retail prices remain essentially unchanged throughout the year, changes in the retail price are driven almost exclusively by changes in the Class I price, including the changes in the over-order premium, received by dairy farmers – when the Class I producer price goes up, retail prices increase, and when the Class I producer price goes down, retail prices decrease.

Because prices at all levels are based on the average costs of a cross-section, less efficient producers, processors, and retailers have an incentive to reduce costs and become more efficient. If they do not, they will either lose business because they must sell at prices above the minimum price, or they will lose money by selling at minimum prices, which are below their costs.

Since 1999, Pennsylvania dairy farmers have received 44% - 57% of the retail price of a gallon of 2% milk. During the same period, processors received 28% - 37% of the retail price, while the percentage received by retailers has been 15% - 17%. The portion of the retail price of milk received by each segment of the dairy industry in Pennsylvania is fair, reasonable, and based on market forces and actual costs.

In addition to the direct economic benefits that the Board provides for Pennsylvania dairy farmers, the Board also provides other benefits. The Board administers and enforces the Milk Producers' Security Act, which requires that purchasers of Pennsylvania producer milk provide security to protect against defaults in payment for that milk. The Board also certifies milk weighers and samplers to ensure that producer milk is measured and tested accurately so that Pennsylvania producers receive accurate and timely payment for their milk.

Thank you for the opportunity to testify today.