Legislative Budget and Finance Committee

A Study of Pennsylvania's Dairy Industry

<u>Report Comments by Stephen Fickes, Project Manager</u>
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Good morning. Mr. Chairman and members of the Committee, it is a pleasure to be here today to discuss the results of our study of Pennsylvania's dairy industry. Before beginning my comments, I want to take a moment to thank the numerous stakeholders, including dairy farmers and processors, with whom we met during our study. Their insights, comments, and opinions were extremely valuable as we conducted our work. More importantly, I want to thank them for educating us on what is truly a fascinating and under-appreciated vocation. I hope our report provides evidence to the difficulties currently facing the industry and Pennsylvania's dairy producers.

As directed by Senate Resolution 384, we conducted a review of the past, current, and future issues facing Pennsylvania's dairy producers and the dairy industry. Our report also offers nine recommendations, which I will discuss in more detail later—but first—it is important to have a basic understanding of the dairy industry's complexity.

The dairy industry is unlike any other agricultural enterprise. Stated simply, milk is highly perishable and it must be collected and processed on a daily basis to meet the needs of consumers. That simple fact creates unique operating challenges that other agricultural endeavors do not face. For example, farmers rely on milk dealers and processors to handle their product. In a similar fashion, dealers and processors rely on farmers to collect high quality milk from their herds. As these parties interact, the economic principles of supply and demand should balance one another and a fair price is generated for each segment. But history has shown that the dairy industry requires special attention to ensure that an even playing field is maintained among all parties. As a result, the dairy industry is perhaps one of the most heavily regulated agricultural sectors.

The dairy industry is often described as being a three-legged stool. Producers, or dairy farmers, who raise and tend to dairy herds, constitute one leg of the stool. Wholesalers, or dairy processors, who process the farmers' raw milk into drinkable fluid milk—as well as other products like cheese, yogurt, and ice cream—constitute another leg. While the final leg, consists of retailers, who sell dairy products to consumers. In Pennsylvania, the interplay of these three "legs" is the basis for Pennsylvania's Milk Marketing Law, which was enacted in 1937, and based on our research, continues to be one of the most robust and comprehensive milk control laws in the country.

I mentioned that the dairy industry was one of the most heavily regulated business sectors. At the federal level, through the United States Department of Agriculture, the industry is regulated by Federal Milk Marketing Orders. Federal Orders cover geographic areas of the country and generally establish a minimum producer price for milk in that area. Milk pricing under Federal Orders is extremely complex and involves sophisticated formulas based on commodity price indices, the milk's end use, and its component content, such as fat and protein. Appendix B of our report shows a high-level overview of how the process works.

Federal Order pricing is significant because it also establishes an end-use classification structure for milk. There are four different milk classifications—with class I milk—or what is commonly known as fluid milk—receiving the highest producer price. These classifications are industry standards for milk transactions, and dairy farmers receive a "milk check" which specifies how their milk was used and the various prices that were paid for that end use.

From a theoretical standpoint, Pennsylvania's Milk Marketing Law overlays the Federal Order system. The Law is administered by the Milk Marketing Board, which is a three member board, with members appointed by the Governor, and confirmed by the Senate. Although the Board has the term "marketing" in its name that is not its primary function. Instead, the Board's primary responsibility is to establish minimum prices for milk transactions within Pennsylvania's borders. Unlike the Federal Orders; however, these minimum prices apply to producers, processors, and retailers.

The Board also establishes a special fee—known as the over-order premium—which is a type of price adjustment paid to Pennsylvania producers for milk that is used for class I purposes. The fee is calculated based on hearings held by the Board, and it is considered to be in addition to the Federal Order price—hence the name, "over order premium." This premium is unique to Pennsylvania—and it applies only to milk which is produced, processed, and sold in Pennsylvania. If any one of those legs is broken—meaning the milk was produced or processed out-of-state, but sold in state, then the fee is not payable to a producer. It is also why setting the over-order premium at just the right "sweet spot" is so important. For example, if it is set too high, then out-of-state milk will become more attractive to processors because it will be cheaper to obtain. Conversely, setting the price too low leaves additional producer profit "on the table." It is a difficult balancing act for the board to factor, and many producers believe an easy answer would be to just ban out-of-state milk from entering Pennsylvania.

However, because of the "Dormant Commerce Clause," within the United States Constitution, the Board cannot restrict interstate commerce and thus it must focus itself solely on milk transactions that occur within the state's borders.

There is an additional reason why a vibrant dairy industry is important to Pennsylvania. The dairy industry is the leading sector within Pennsylvania's agricultural economy. In fact, as part of our report, we calculated various economic impacts generated by the industry and found that as many as 45,000 jobs are supported among the three legs of the dairy industry generating more than $1.8 billion in wages in 2017. When factoring all the direct, indirect, and induced economic impacts, the dairy industry equaled nearly four percent of the state's gross domestic product. We also calculated these impacts on a county by county basis, which appears on exhibit 21 of our report (page 49).

Moving to the current issues facing the dairy industry, the primary problem is one of low milk prices for producers. The dairy industry has always had ups and downs with swings in pricing based on seasonal demand and supply. However, beyond these normal swings, for the past five years—which is the longest period in recent memory—dairy producers have had to endure a period of sustained low prices. In turn, with the ever increasing costs of production, dairy producers are financially strained and many are leaving the industry. In fact, over the past decade, the number of dairy farms has decreased by 19 percent—although in a glimmer of positivity—that decline is not as great as in similar states like Wisconsin, which have seen larger decreases in the number of dairy farms.

Of greater concern to Pennsylvania's dairy industry; however, is the loss of dairy cows. During that same period, the number of cows decreased by 5 percent, with larger decreases in the last quarter of 2018. This trend is concerning because it means that production capacity is leaving the state. Other trends are also apparent within the industry, including a push toward larger dairy operations and vertical integration between the processing and retail segments of the dairy industry. These latter aspects may change the face of dairy farming in Pennsylvania.

The reason for low producer prices is not easily explained by any one factor, but rather it is the result of numerous factors, many of which are occurring beyond the borders of Pennsylvania and even the United States. Ultimately, the problem comes down to the issue of too much supply and not enough demand. Too much supply can be explained by certain factors involving farm and processing efficiencies, but the declining demand for certain classes of milk—particularly class I fluid milk—is a real concern for Pennsylvania producers.

Currently, data on Pennsylvania consumption of dairy products is unavailable. However, we were able to use national data as a reference point. We reviewed fluid milk consumption since 1975, and found that since that time, there has been a 40 percent decline. This decline is attributable to market saturation among dairy products and the increased marketing efforts of plant-based milks as healthier alternatives to dairy. In fact, while fluid milk continues to decline, plant-based milks have skyrocketed. For example, plant-based milks have increased sales by 61 percent between 2012 and 2017. Although there are numerous types of plant-based milks, almond milk continues to be the leading plant-based milk with about 64 percent of the market share—and an increase in sales of 10 percent in just 2018.

It is important to note that despite seeking the identity, texture, and general appearance of dairy milk—according to the federal government—plant-based milks are <u>not</u> milk. According to the Code of Federal Regulations, only milk which is collected from cows may be labeled as milk. Plant-based milks are, in fact, suspensions of dissolved, or extracted plant material in water, which are then fortified with emulsifiers, sugars, proteins, and other ingredients to simulate dairy milk's consistency and nutritional content. The products are packaged in similar containers, and sold alongside traditional dairy products—but they fail to meet the strict identity requirements of milk.

To date, the Food and Drug Administration (FDA) has failed to enforce this product identity requirement. The FDA has held two comment periods, but no conclusive action has resulted from that effort. During our stakeholder interviews, we were frequently informed of the unfairness in allowing plant-based milks to be marketed as milk and sold alongside traditional dairy products. Many producers view the increasing presence of plant-based milks as a direct threat to their livelihood and the dairy industry as a whole, which brings us to our study's first recommendation.

As I mentioned earlier, Pennsylvania's Milk Marketing Law allows for broad authority to regulate milk and to ensure fairness in the marketplace. Along these lines, the Law also defines milk in a way that is product-centered, instead of using the federal government's definition, which is source-centered. To that end, we recommend that the Board use the powers granted to it under the law and create a special classification of milk, known as class V milks, which would include specifically all plant-based milks. With this designation, the Board could establish a premium on these products, which would then be deposited into the Milk Marketing Fund for use in defraying the costs of implementing the law.

We acknowledge that this is a different tactic and some may oppose the concept of acknowledging plant-based milks as a type of milk—but we also think there are very sound reasons for pursuing this action.

Primary among these reasons is that the current regulatory activities are funded through licenses and fees on various entities involved in the dairy industry—yet, plant-based milks—which also use the same name and same market access as traditional milk products, pay nothing. Furthermore, the Board is considering raising fees on milk dealers and others to fund these necessary costs. Accordingly, it makes sense to first correct this inequity by instituting a premium on plant-based milks, before raising fees on already troubled segments of the dairy industry.

As for our remaining eight recommendations, they cover a broad range of topics including the following:

- Eliminating the current 17 day sell-by date, which is an arbitrary date placed on fluid milk containers and serves to only confuse consumers.
- Licensing retailers, so that better data can be captured on milk sales, including milk which may have been processed outside of Pennsylvania.
- Expanding research and development assistance, and making it a priority within the Dairy Investment Program.
- Developing a strategy to overcome the large lead held by other states in cheese processing capacity.
- Developing a campaign beyond Pennsylvania's borders so that consumers can identify Pennsylvania with quality fluid milk, much like Florida is associated with orange juice.
- Expanding the size of the Milk Marketing Board and changing its name to better reflect its actual regulatory duties.
- And finally, improving the transparency and accountability with the over-order premium, so that every producer, regardless if they are a member of a cooperative or an independent, can clearly know how much they are being paid.

In closing, I want to thank the staff and members of the Pennsylvania Milk Marketing Board and the Pennsylvania Department of Agriculture for their assistance and cooperation as we completed this study. I would also like to thank analysts Stevi Sprenkle, and Joe Asare, of our team. Each of these members were invaluable in gathering and collecting information for this report. I'd be happy to answer any questions you may have. Thank you.