Testimony Prepared for Mideast Federal Milk Marketing Order Hearing by Smith Dairy Products Company
Wooster, Ohio
March 9, 2005

Introduction

My name is Eddie Steiner. I am employed by Smith Dairy Products Company and am the person primarily responsible for Smith Dairy's milk handling program. I do not consider myself an expert on federal orders. My testimony today is on behalf of Smith Dairy and its subsidiary, Wayne Dairy Products, Inc of Richmond, Indiana.

I also believe that the views expressed in this testimony are consistent with the desires of the vast majority of independent producers who ship their milk to Smith Dairy. However, the positions our company takes today have not been reviewed with every independent Smith producer, nor with the majority of Smith producers, and I have not been appointed or elected by these producers to represent their views.

My belief that this testimony represents the majority viewpoint of producers shipping to Smith's is based on numerous phone calls received from, and personal conversations with, Smith producers and haulers over the past several years; and with several producers who contacted me personally subsequent to the announcement that this hearing was being held.

Company Background

As background, Smith Dairy operates two handling plants, both located in the Mideast Order. The first plant is in Orrville, Ohio which is in the northeast portion of the state, about an hour's drive south of Cleveland. Smith's second plant is in Richmond, Indiana, which is on the eastern edge of Indiana, straight west of Dayton and Columbus.

At Orrville, Class I sales account for approximately 71% of the volume, with Class II contributing about 14%. At Richmond, Class I sales account for about 70% of the volume, with Class II at about 15%. Thus, Class I and II sales account for about 85% of the sales volume at each of our plants.

Smith Dairy employs about 325 people at Orrville, 100 people at Richmond, and 70 people at five distribution branches in Ohio localities. Company-wide employment averaged about 490 persons in 2004, including seasonal and part-time workers.

The majority of milk supplied to Smith's two handling plants comes from independent producers, farms that are not members of a cooperative. In December 2004, 213 producers supplied 80% of the milk receipts at Orrville. An additional 3% of December's volume was supplied from our Richmond plant surplus, with the remaining balance of receipts supplied by the DFA cooperative.

We believe our producer base has similar characteristics to the overall producer base in Order 33, as most of our farms are small entities. The average monthly milk shipped by each Orrville producer was about 108,000 pounds in December.

At Richmond, 94% of its December milk receipts were supplied from 78 independent producers located primarily in eastern Indiana and western Ohio, with the remainder received from DFA. In addition, to balance its milk supply and demand, the Richmond plant diverted approximately 13% of its independent producer milk in

December. Approximately two-thirds of the diversions were sent to our Orrville, OH plant for bottling, with the remainder sent to other Mideast area plants.

In 2004, Smith Dairy's Orrville plant balanced excess milk supplies by diverting an average of 4% of its independent milk supply to a Mideast Order cheese plant with monthly amounts ranging from less than 1% to just under 7%. Smith Dairy's Richmond plant also diverted some of its non-member milk supply, with portions ranging from 0% to 9% diverted to our Orrville, Ohio facility; and 0% to 16% diverted to other Mideast Order outlets in Ohio, Indiana and Michigan. Monthly diversions of Richmond's independent milk supply averaged 9% in 2004.

Support for the Conceptual Intent of Proposals 1 - 8

In relation to the primary matters being heard at this hearing, those of pooling performance requirements, the ability to simultaneously pool on both the Mideast order and a state order, and voluntary depooling due to pricing anomalies, Smith Dairy supports the expressed intent of Proposals 1 through 8 to address these practices which have resulted in reduction of producer pay prices in the Mideast order. We consider such practices to be manipulative of the Order and harmful to the producers located in the Order area who consistently serve this Order's marketplace. We believe that pool riding, also referred to as paper pooling, and voluntary depooling for the purpose of taking economic advantage of short-term price inversions are materially harmful to producers in the Mideast order, including independent producers supplying Smith Dairy's plants.

Rather than speak in specific support of any of the individual Proposals 1 through 8, Smith Dairy urges the Secretary to amend Mideast Order provisions in such a manner as to eliminate, to the fullest extent possible, those referenced practices which result in dilution of the Order 33 PPD. We therefore request the Department to modify the performance standards, and rules regarding dual-pooling and depooling in such a way as to limit milk pooled on the Mideast Order to that milk which continuously supplies regulated plants within the Order area, and to require continuous pooling of such milk on the Order.

We recognize that such rule construction would need to allow for significant changes in market conditions, either market-wide or potentially with an individual handler or supply organization. As one example, a significant shift in Class I volumes triggered by a change in customer base should be able to be accommodated under the revised rules in such a way as to not preclude a supplier or handler from being able to pool milk to meet those needs. We believe the Department should retain the right to make such adjustments on a specific case basis as it deems appropriate.

<u>Statement in Opposition to Proposal 9 – Transportation Credits</u>

On another matter, Smith Dairy wishes to comment on Proposal 9, which would establish a transportation credit provision on some milk delivered from farms to pool distributing plants. We believe transportation credits would further reduce producer pay prices, ~~and~~ that such credits are unnecessary in the Mideast order, and would likely create significant administrative burden for the Department with resulting costs that would need to be borne in some manner by the dairy sector.

We believe the Department should recognize that physical movement of Class I milk within the Mideast order is more a handler issue than a producer issue, and ask the Department to consider the following:

First, the vast majority of Class I milk sales are the result of producer milk being transported originally from the farm to the handler and then on to the point of retail sale. The proposed transportation credit speaks to the segment of transportation where milk moves from producer to handler, but is silent on the segment where milk moves from handler to point of retail sale. There are several problems with such an approach:

The movement of milk from producer to handler occurs in bulk tankers which can efficiently transport larger quantities than can be accommodated by vehicles moving packaged product from handler to retail outlet. The ability to move milk efficiently from the farm to Class I handlers supplying the Mideast order is demonstrated by the regular patterns of milk movement that have developed in the marketplace.

For example, Smith Dairy's Orrville, Ohio plant receives the majority, though not all, of its independent producer milk from farms located within 75 miles of its plant. While we don't have a precise breakdown, we know that about 23% of our daily patron milk is transported between 50 and 90 miles to reach our Orrville, OH plant.

At the same time, transportation costs for delivery of product from our Orrville plant to its retail destination are substantial. A fair portion of our customer base is located in the greater Columbus area and points west of Columbus. We have customers located throughout Ohio, including the northwest and southeast corners of the state, and a few wholesale delivery customers across state lines. As a result, about 44% of our Class I milk sales are to delivery points in excess of 75 miles from our bottling plant.

The same is true for our Richmond, Indiana bottling facility, where over one-third of its independent producers are located more than 50 miles from our plant. We should note however, that at Richmond, no independent producer is located more than 75 miles from our plant. On the delivery side, approximately 37% of Richmond's Class I sales are transported to outlets more than 75 miles from the bottling plant.

We believe similar distance issues are faced by quite a number, if not most, of the Class I handlers in the Mideast order. Sometimes these conditions are related to supply relationships with large, multi-location customers, sometimes simply from competitive market conditions. Various examples can be cited from general industry knowledge of current market conditions, and relevant previous testimony and exhibits from this hearing. A few such examples are:

A large supermarket chain in northern Ohio being served from a plant in Sharpsville, PA (with some raw milk apparently moving from the Wayne/Medina county Ohio area to Sharpsville, and some bottled milk moving from Sharpsville to Medina County Ohio).

A large supermarket chain in the greater Detroit area being served with milk from Canton, Ohio.

A supermarket chain located around the state of Ohio being served by a plant in Newark.

Many school districts around the state of Ohio are served with milk that has been bottled at a point more than 75 miles distant from the school.

The same holds true for many restaurants, hospitals, nursing homes, and other points of Class I disposition.

Thus, each Class I handler plant has its own set of dynamics when it comes to proximity to its milk supply and to its customers. In some cases, a handler will be located generally closer to its supply base than to its customer base; in other cases, the reverse will be true. Yet, in many cases and with almost constant frequency, Class I handlers in Order 33 compete against each other regardless of their particular set of circumstances relative to location of milk supply and customer base. The geographic location of a particular handling plant is a handler decision. If a handler chooses to locate a plant in proximity to a supply base and at a distance from their customer base, or vice versa, close to their customer base but at a distance from existing milk supplies, that is a handler decision. The handler's business model needs to account for total transportation costs from farm to customer market.

A second point to be considered relative to the handler nature of the transportation credit issue is that of milk supply agreements. A number of handler plants in the Order have milk supply agreements, sometimes full supply agreements, with a given agency or cooperative. This appears to be true for a number of the plants in the Southern Ohio Region. These supply agreements are the result of two parties, a milk supplier and a milk handler determining that it is in the best interests of their respective entities to enter into such an arrangement. These entities have, through process of negotiation or other price discovery methods, determined the fees that the supplier will charge and the handler will pay for performance according to the supply agreement. The financial terms of those agreements must have been acceptable to both parties, or one or both parties would not have entered into such agreement. We do not know the particulars specified in the existing supply agreements, but we are aware that across the industry some supply agreements specify how additional costs, foreseen or unforeseen, should be handled. For example, if a handler needs more milk than contracted for, he may have to pay additional transportation costs, or on a spot basis costs which could include what are commonly known as "give up" fees. And some raw milk suppliers have added or negotiated fuel surcharges during periods of high fuel costs. We believe that if a party to such a raw milk supply agreement now finds that the fees involved are not acceptable, it should be a matter handled within the context of that supply agreement, by the two entities directly party to that agreement. The impact of Proposal 9, in situations where there are supply agreements of the nature just described, would be to introduce additional parties to share in the cost of the agreement negotiated between the original two parties. In fact, Proposal 9 would require producers whose milk never serves that particular handler's needs to subsidize the cost of the supply agreement that has been made. This reduces the pay price for producers not involved in the supply agreement, something that we do not believe to be appropriate.

Proposal 9 could also potentially have another harmful unintended consequence. That consequence would be that a Class I handler located in the southern part of the Mideast order could be able to have a portion of its total transportation cost for milk (cost from farm to dairy to store) subsidized. This could result in a competitive advantage for that Class I handler over other Class I handlers who serve the same milk consumption market. In other words, a Class I handler located in northern Ohio and supplying accounts in southern Ohio may be able to compete effectively today, in the absence of transportation credits, but could find its ability to compete effectively in southern Ohio reduced due to the subsidized transportation cost afforded to a handler located in southern Ohio. Thus, Proposal 9 risks an anti-competitive impact in the marketplace, giving a cost advantage to plants located in certain geographic areas by transferring some milk transportation costs away from that handler's supply arrangements.

Some of the proponents of a transportation credit believe all pooled producers should share in the transportation costs of the marketplace. I believe we have heard testimony to that effect at this hearing. Yet the proposal at hand does not equally apportion all transportation costs of the Mideast market, nor does it preclude such costs from being inflated due to inefficient movement of milk, or costs incurred as a result of milk movements not directly benefiting the Mideast Order.

For example, as we understand the language of Proposal 9, a supply organization would not be precluded from shipping milk out of the Mideast area to meet another area's needs, and then need to transport milk further within the order, or even from another order, to replace the milk its shipped out of the order. The impact of such action could likely be that transportation credits would be generated for milk moved to serve the Mideast order, yet the root cause of the transportation expense incurred could have been the original decision to move existing Mideast area milk to another order. The end result of such action is that producers across the Mideast order would receive a lower PPD because of someone's decision to send milk out of the Mideast order.

Based on all of the above reasons, Smith Dairy opposes adoption of a transportation credit provision in the Mideast order.

Emergency Situation

Over the past several years, a number of independent producers shipping to Smith Dairy's two handling plants have told us that depooling and paper pooling practices are causing financial harm to their farm operations. Events in 2004 appear to show that the situation is worsening. We believe such practices have led to conditions that constitute an emergency situation in the Mideast Order. We therefore, ask the Secretary to expedite the process of amending these rules. However, we also recognize that constructing sound regulation that yields intended results, and avoids material unintended consequences, is not an easy process. As such, we believe the Secretary should use all resources at the Secretary's disposal to place very high and constant priority on these matters.

Concluding Statement

In summary, Smith Dairy supports in general the stated intent of Proposals 1 through 8. Rather than speaking in favor of certain specific proposals, we urge the amendment of Mideast Order regulations in such a way as to effectively eliminate "dual-pooling", "paper-pooling" (a.k.a. "pool-riding"), and voluntary depooling that takes economic advantage of price anomalies related to class pricing inversions.

Smith Dairy opposes the concept of a transportation credit where such monies come out of the pool, and therefore, we speak in opposition to Proposal 9.

We express our appreciation to the Secretary, USDA staff, and especially the Mideast Market Administrator's office for each of their roles in conducting this hearing; and for providing us the opportunity for input in this process. Thank you.