

BEFORE THE UNITED STATES DEPARTMENT  
OF AGRICULTURE  
AGRICULTURAL MARKETING SERVICE

In the Matter of

Milk In The Northeast

Marketing Area

-  
: Docket Nos.:  
: AO-14-A70 et al;  
: DA-02-01

Testimony of

Edward Gallagher  
Vice President  
Dairylea Cooperative, Inc.

on behalf of the  
Association of Dairy Cooperatives  
in the Northeast

Proposals 2, 3, 4, 5, 6, and 10

September 13, 2002  
Alexandria, Virginia

#### **Proposal 4**

Payments from the producer settlement fund are presently required to be disbursed by the 16<sup>th</sup> of the month. Proposal 4 from the hearing notice seeks to change the “16<sup>th</sup>” to “the day after the due date required for payment” to the producer settlement fund. The intent of this proposal is to provide a more orderly disbursement of funds. Under current provisions, the 16<sup>th</sup> of the month sometimes is the same day that payments into the producer settlement fund are made. Identification of the “16<sup>th</sup> of the month” was a Federal Order Reform aspect that slipped by our collective purview of the proposed changes. If recognition of this aspect had occurred during the Federal Order Reform review process, the ADCNE cooperatives would have asked for the change which we are seeking at this hearing.

#### **Proposal 5**

ADCNE’s requests changes to Section 1001.7 to limit the ability of vast quantities of milk, not produced near the Northeast and not, in any meaningful amount, delivered to distributing plants pooled under the Northeast Order, from being pooled under the Northeast Order. Known as “opportunistic pooling”, the liberalness of Section 1001.7 and its resulting impact on blend prices under the Northeast Order, is an unintended consequence of Federal Order Reform. ADCNE’s requested changes will limit the potentially abusive pool riding that could occur on the Northeast Order. This abusive pool riding could lead to vastly lower blend prices, reduced milk production within the Northeast, and a longer term inability for Class I distributing plants from being adequately supplied.

These proposed changes are not meant to prohibit milk produced in distant production regions from being pooled under the Northeast Order. Instead, the changes are meant to limit such pooling to that which has a regular association with distributing plants pooled under the Northeast Order. Under the Order’s current provisions, a manufacturing plant in a distant area could become a pool plant under the Northeast Order in the fall months, by delivering a small portion of its plant receipts to an Order 1 distributing plant. It then could remain a pool plant during the subsequent months of January – July with out shipping any milk to a pool distributing plant. As a pool plant with no pooling requirements, it could ultimately pool the entire milk production of the state in which it is located.

There are two aspects of Section 1001.7 that need to be dealt with in order to prevent what has become known as opportunistic pooling and thereby reinforce the integrity of the Northeast Federal Order. Both aspects are mutually inclusive and need to be dealt with swiftly and simultaneously.

The first aspect is the elimination of subsection 7 of Section 1001.7. The order language in subsection 7 is more popularly known as the “split-plant” provision. This provision allows a pool plant to designate a portion of its plant as a non pool plant. The use of the split plant provision creates two “paper accounting” plants out of one physical plant location and it serves to facilitate opportunistic pooling on the Northeast Order.

The second aspect relates to the Northeast order's supply plant shipping provisions. Presently, to qualify as a pool plant under Section 1001.7(c), a manufacturing plant is required to transfer or divert at least 10 percent of its plant receipts, to a pool distributing plant, during the months of August and December, and transfer or divert at least 20 percent, to a pool distributing plant, during the fall months of September, October and November. If a manufacturing plant meets these requirements in each of the months of August – December, the present Order language allows such a plant to automatically be a pool plant during the subsequent January – July, including the entire flush period. Meeting the August-December pool plant requirements, allows a manufacturing plant to pool unlimited amounts of milk on the Order No. 1 pool without having to ship a single load of milk to a pool distributing plant.

Manufacturing plants that have set up their operations to take in both Grade A and Grade B milk can best take advantage of the split plant pooling provision that ADCNE is attempting to change. Such plants can utilize this provision to “skinny” down the Grade A plant receipts to make it easier for them to become a pool plant under a high Class I utilization, and ultimately, high producer price differential, Order. Here's how.

Take, for example, a cheese plant located outside of the Northeast that takes in 62 million pounds of milk in a month that can be treated as two plants – a Grade A plant and a Grade B plant. For every one load of milk transferred from the Grade A plant to a pool distributing plant under the Northeast Order, the manufacturing plant can take delivery at the Grade A plant and pool on the Northeast order, an additional 9 loads, during August and December. By doing this, the Grade A plant meets the requirements of a pool plant for those months. The remaining milk purchases, amounting to 1,230 loads of milk are delivered to the same physical facility, but to the cheese plant's Grade B plant side. These loads, plus the 9 loads on the Grade A side that aren't shipped to a pool distributing plant, are used to manufacture cheese. Since the milk at the Grade B side of the plant, is Grade A and can be pooled under Federal Orders, the cooperative operating the plant can use provisions in the “local” Federal order - to get the milk pooled on that “local” order.

During the fall months of September, October and November, 2 of the 10 loads delivered to the Grade A side would be delivered to a pool distributing plant in the Northeast Order, to qualify the Grade A side of the plant as a Northeast order pool supply plant.

Once accomplished each month during the August – December, the Grade A side of the plant automatically becomes a Northeast order pool supply plant for the subsequent months of January-July. However, there is no requirement to ship any milk to a Northeast Order distributing plant, again, until August. Instead, all the milk delivered to the Grade A side can be utilized in the production of cheese, diverted to the Grade B side or diverted to another cheese plant nearby.

The Northeast Order has an appropriately liberal one-day touch base provision. After the equivalent of one-day's milk production of a farmer is delivered to a Northeast

Order pool plant, that farmer can become a Northeast Order producer. The farmer maintains Northeast Order producer status as long as his/her milk is associated (i.e., pooled) with the Northeast Order pool each subsequent month, and the producer's milk is not delivered to a non-pool Class I plant on any day.

Back to our example, the Northeast Order touch base provision means that any producer, whose milk is on a load that is delivered to the Grade A side of the plant, meets the qualifications to have his/her milk pooled under the Northeast Order. During the August – December qualifying period, the supply plant shipping provisions limit the amount of milk that can be pooled and limits the amount of milk that would be delivered to the Grade A side. However, during the free pooling period of January-July, any farmer delivering just one day to the Grade A side becomes eligible for Northeast Order pool producer status.

It is here, during this period, where the real threat of pool-riding abuse can occur. Now a single plant has the theoretical ability to pool 100 percent of its state's milk production on the Northeast Order pool. Here is why.

In my example of a split plant purchasing 62 million pounds of milk per month, this equates to 2 million pounds of milk receipts per day. Although not strictly the case, let's assume that the 2 million pounds per day represents two-days milk production on about 300 farms. By juggling routes, it is theoretically possible to qualify 9,300 producers (300 farms X 31 days) for the pool. This would then allow, via diversions, the split, manufacturing pool plant to pool 961 million pounds of milk (9,300 farms X 3,333 pounds per farm per day X 31 days) on the Northeast Order in January. During February, the same rotation procedure could be used to pool qualify another 8,400 farms and an additional 784 million pounds of milk. Since 961 million pounds could have been qualified in January, a total of 1.7 billion pounds of milk could be pooled on the Northeast Order during February. As you can see, it doesn't take to many months before a state as large as California could have 100 percent of its monthly milk production pooled on the Northeast Order.

Recapping this example, the Northeast Order provisions present the opportunity for a manufacturing plant, of any intake capacity – from 2 loads per month to 150,000,000-plus pounds of milk per month, in the heart of a distant marketing order's milk shed, to deliver a total of 8 loads of milk, about 400,000 pounds of milk, during August-December, and qualify as a pool plant during the subsequent January-July. Upon achieving this, the particular plant, not only can pool 100 percent of the milk it uses for manufacturing at the plant, but all the milk produced in the state in which it is located, during the subsequent January-July.

For manufacturing plants located in states outside of the Northeast Order, that purchase milk in the milk shed of a marketing order with a producer price differential or blend price that is lower than the Northeast's, the potential economic harm to the Order No. 1 pool can be significant and place at risk:

- ❖ its producer price differential level,
- ❖ the economic, financial and psychological impact on the Order 1 pool producers in the Northeastern states, and,
- ❖ the ability of cooperatives and handlers to maintain a competitively priced milk supply that meets the needs of the Class I handlers and dealers.

Although not currently to this extreme, the potential ability for this to occur should be corrected. Ultimately, taken to an extreme, the ability for Northeastern Class I and manufacturing plants to compete in regional and national markets could be harmed.

Continuation of these provisions, as is, is unnecessary to the fulfillment of the purpose of the Northeast Order. At present, the provisions discussed serve to create the potential disorderly marketing conditions that could undermine the strong and vibrant dairy industry in the Northeast.

ADCNE strongly recommends the following changes to reduce potentially harmful effects of opportunistic pool-riding:

- ❖ Eliminate Section 1001.7(c)(3) which allows for manufacturing plant to obtain “free-ride” pooling during January-July if during each of the prior months of August-December the plant met the pool plant provisions.
- ❖ Amend the provisions of Section 1001.7(c)(1) to create year round supply plant pool requirements. Currently, there are year round requirement that are imposed on manufacturing plants that do not meet the August-December qualification requirements.
  - ↳ These requirements are that during the months of January-August, and December a minimum of 10 percent, and during September-November, a minimum of 20 percent, of plant receipts are received or diverted to Northeast Order pool distributing plants.
  - ↳ ADCNE requests that 1001.7(c)(1) be amended to incorporate the 10 percent shipping requirements of January-August and December, and the 20 percent shipping requirements of September-November, as the regular monthly, year round, shipping requirements for pool supply plants.
- ❖ Eliminate Section 1001.7(h)(7) which allows for split plants.
- ❖ Make the requested adjustments in 1001.7(g) that correspond to our marketwide services proposal.
- ❖ Redesignate paragraphs 1001.7(c)(4) and (c)(5) as paragraphs (c)(3) and (c)(4).

Exhibit x, Table 1 estimates the impact to the producer price differential as a result of milk being pooled in the manner described above. The pounds highlighted under the heading “opportunistically pooled” are estimated from a table in Exhibit 5 presented by Peter Frederick’s of the Northeast Order Market Administrator’s Office. To get the “opportunistically pooled” pounds, I took Peter’s monthly numbers and subtracted

three million pounds. This subtraction was made based on my estimates of the milk associated with the Northeast Order pool due to the Order 1 pool distributing plant located in Utah.

The analysis I went through shows that for the 18 month period from January 2001-July 2002, the Northeast Order producer price differential was reduced by an estimated \$.016 per hundredweight. This varied from a high of \$.051 reduction, to an increase of about \$.01, on a monthly basis.

The changes ADCNE is recommending will likely restore most of this value to the producer price differential and improve prices to all Northeast Order producers. Although the amount of the reduction on the Northeast Order producer price differential is not as great as occurred in other Orders, due to pool-riding activities, it nonetheless is an unnecessary cost to the pool. More importantly, the potential extent of the harm to the pool could so severely lower the Northeast's producer price differential that these changes must be made on an expedited basis and be implemented prior to January 1, 2003.

During the Federal Order Reform process, ADCNE was a proponent of the "free-ride" provisions for the subsequent January-July, but did not request the split pool plant provision. During the Federal Order Reform comment period, ADCNE did not recognize the significance of the split plant provisions, in combination with the "free-ride" provisions, could have on the Northeast Order producer price differential. This hearing is the first opportunity we have had to correct this unintended consequence of Federal Order Reform. Due to the need to correct this issue prior to the beginning of the next free-ride period that begins in January, ADCNE requests an emergency and expedited implementation of this proposal by January 1, 2003.

During the ADCNE deliberations of the formation of the Northeast Order, Dairylea and DFA had been proponents of allowing the "free-ride" provision. It was our goal to create a set of Federal Order provisions that were fair to all handlers previously pooled under the former Orders that were to make up the Northeast Order. Dairylea and DFA recognized that it would be important to have the "free-ride" provisions so that Friendship Dairies, Pollio, Kraft, Chateaugay Cooperative and Dietrichs Milk Products would all be able to maintain their direct producer shippers and to pool the milk during the early implementation of the new Order. Since implementation of Federal Order Reform, one of these businesses chose to make their producers non pool. Presently, all of the direct shippers to each of these businesses are pooled by Dairy Marketing Services. Due to the changing business relationships in the Northeast Order and the continuation of provisions that allow proprietary plants to pool their independent shippers if they so choose, the Northeast Order's "free-ride" provisions serves no useful purpose and should be eliminated. Also note, any handler currently meeting the 20 percent shipping requirements in September through November, would not be disadvantaged by the imposition of year round shipping requirements since the January - July percentages would be lower than those they would be meeting in the fall.

My ADCNE colleagues and I have reviewed New York State Dairy Food's proposal number 2. ADCNE supports the parts of this proposal to the extent that it is similar to ours regarding split plants and shipping provisions. However, their proposed increase in the August - December shipping provisions is unwarranted and could lead to disorderly marketing conditions in that some handlers, currently pooling milk on the Northeast Order, could be forced to depool producers.

Additionally, the NYS Dairy Foods proposal has not closed the loophole in the Order regarding the free-ride shipping provisions during January - July. Their proposed changes do not present the appropriate safeguards to the integrity of the Order. Although a portion of their proposal number 3 would require 25 percent of receipts to be shipped to pool plants during January-July, this does not insure that Class I distributors receive milk, nor does it limit the potential pool riding ability for a distant region's manufacturing plant. These things being the case, proposal 2 should be rejected.

Friendship Dairies proposal number ten has also been reviewed by ADCNE. Again, ADCNE supports it in that it maintains shipping provisions during August through December. However, it does not address the free-ride months of January - July, and its reduction in the level of the shipping provisions would not be an improvement to the Northeast order. As a point of note, we believe the reference to paragraph (f) in 1001.7(c)(3) is incorrect. We believe the correct reference should be paragraph (g) not paragraph (f).

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**Proposal 6**

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The changes to 100 1. 13(d)(1) were requested so that the Order language is clearer relative to the interpretation of this provision. Presently, the touch base for a producer is one day. Once a producer's milk is delivered to a pool plant during the month, at any time during the month, the producer's milk is eligible to be pooled for the entire month, and any subsequent month, provide the producer remains a pool producer under the Northeast Order. If such producer does not have any of his/her milk pooled under the Northeast Order in a subsequent month, such farm must reestablish itself with the Northeast Order by having his or her milk delivered to a pool plant some time during a month.

The Northeast Order does not have any year round diversion limitations for pool distributing plants.. Although, there aren't specific diversion limitations for pool supply plants, the monthly shipping requirements, if any, have been defacto diversion limitations. That is if a plant or 9(c) cooperative has to divert 10 percent of its receipts to a pool distributing plant, it then becomes limited to diverting no more than 90 percent of its receipts to a non pool plant. We believe these also apply to pool distributing plants.

The lack of specific diversion limitations, on a year round basis, under the producer milk provisions needs to be corrected

The lack of diversion limitations on distributing plants means they can divert significant amounts of milk off their plant during January - July – limited only by economics and the amount of milk that can be delivered to their plant. Ultimately, this could mean that one pool distributing plant could pool an entire region's milk production. Here's an example of how it could happen.

Suppose a pool distributing plant needs 37 million pounds of milk. It receives this milk from 200 farms that produce 3,000 pounds every day. Since there are no "defacto" diversion limitations at pool distributing plants during January-July, each day, 200 different farms could supply milk to the plant. Since one day's farm production was received at the pool plant the producer is qualified for the Order No. 1 pool until such farm's milk is no longer reported as Order No. 1 pool milk. So in January, this plant could qualify 577 million pounds of milk. In February, the distributing plant could qualify an additional 521 million pounds for the Order No. 1 pool and allow that plant to pool 1.1 billion pounds. In a few months, the plant could theoretically pool all the milk in the Northeast on Order No. 1.

Although I don't illustrate them here, there is a potential pool riding opportunity for milk produced outside of the region and taking advantage of the lack of diversion limitations at pool distributing plants. ADCNE requests swift and immediate resolution to this issue by implementing our proposal on an emergency and expedited basis.

During the Federal Order Reform process, myself and other members of ADCNE failed to recognize this loop hole in the Northeast Order. If we had, we would have pointed this out to Dairy Division and requested the diversion limitations that we are requesting at this hearing.

The application of our request is fairly straight forward. ADCNE requests year round, monthly diversion limitations that would be 1 minus that month's shipping provision. This, then, would be diversion limitations of 90 percent during December – August and 80 percent for September-November. Additional language is suggested that milk that is over diverted shall not be producer milk and that the Market Administrator shall depool all non pool plant deliveries if the over diverting handler doesn't cooperate with the Market Administrator by designating producers whose milk will be depooled.

ADCNE requests that any milk depooled due to over diversion is not treated under the dairy farmer for other markets provisions and is allowed to be pooled again the following month and will not carry the dairy farmer for other markets penalties.

Also, ADCNE is requesting that the Market Administrator be given the same authority he presently has with supply plant shipping provisions and that other Market Administrators have in their Orders with diversion limitation percentages. Namely, to be able to administratively adjust the percentages as market conditions warrant. Truly this is an amendment that is more procedural than strategic. It is the intent of ADCNE to maintain the diversion percentages at 1 minus the shipping provision percentages. If the



shipping percentages are adjusted administratively, then the diversion percentages also need to be so adjusted.

ADCNE also recognizes the unfairness of allowing the same milk to be pooled on a state order, utilizing minimum pricing and marketwide pooling of the Class price proceeds, and a Federal Order. To my knowledge, such double dip pooling is not now occurring on the Northeast Order. However, due to the presence of the Western New York State Milk Marketing Order within the milk shed of the Northeast Order, and the knowledge of double dip pooling of California milk, elsewhere, the Northeast Order should be amended to prevent this from occurring.

The addition of paragraph 1001.13(e) was specifically worded to make the double dipping prohibition effective on state order milk that utilizes minimum class pricing and marketwide pooling of the class price proceeds. This would certainly entail milk pooled under the Western New York State order and California's state order. However, it would have no impact on milk priced under state pricing programs such as those operated by the Pennsylvania Milk Marketing Board, the Maine Milk Commission, the former Northeast Dairy Compact or the Virginia Milk Commission. Under these state pricing programs, state mandated Class I premiums are paid to producers delivering milk to Class I plants under their regulation. In the case of Virginia Milk Commission, Maine, the Dairy Compact and possibly under the PMMB, these Class I premiums are pooled and paid to a wider group of farms than those actually delivering to the Class I plants. Allowing milk that is priced under state milk pricing regulations like those mentioned would maintain orderly marketing conditions within the Northeast Order. Using this proposed amendment to depool milk priced under the four Northeastern state programs would cause serious disorderly marketing conditions as it would impinge on the ability for Northeast Order pool distributing plants from maintaining an adequate supply of milk for their needs.

Additionally, ADCNE requests that the present 1001.13(d)(2) be redesignated as 1001.13(d)(3).

My ADCNE colleagues and I have reviewed New York State Dairy Foods proposal number 3. To the extent that it is similar to our proposal number 6, in that it maintains a touch base provisions, would implement diversion limitations, and give the Market Administrator discretionary authority to adjust the diversion limits, ADCNE supports its. However, ADCNE does not support their:

- ❖ two-day touch base provision,
- ❖ request to have milk "touch based" in August through December, and
- ❖ restrictive levels of their diversion limitations.

Implementation of proposal 3 could cause disorderly markets as it would significantly raise the cost of producers maintaining their pool eligibility. It could prevent some producers located in the Northeastern states, and who have been regularly pooled on the Northeast order or its predecessor orders, from retaining pool producer

status. If milk was forced off from the pool, it could undermine premium markets and blend prices throughout the Northeast.

