Testimony of Paul G. Christ
at the hearing to consider amendments
to Federal orders 5 and 7,
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Proposal No. 7

My name is Paul G. Christ. I reside at 245 Indian Trail, So., Afton, Minnesota 55001. I appear here as a dairy consultant with 40 years of experience in working with Federal milk marketing orders, both as an employee of the Dairy Programs of the Agricultural Marketing Service, and as a vice president of Land O'Lakes, Inc. During this time I have been exposed to nearly all issues related to Federal milk orders, and participated in the development of many of the current provisions of milk orders.

I am testifying here as an advocate for Dean Foods Company and my testimony is intended to support proposal No. 7 and that would place certain limits on the size and flexibility of producer-handlers in Federal orders No. 5 and No. 7.

1. It is my view that exemption from the pricing and pooling provisions of a Federal milk order should be a rare and highly restricted privilege. The foundation for this view is my belief that the basic purposes of a Federal milk order are to:

   a. Assure an adequate supply of milk for fluid uses, and;

   b. Enhance the returns to milk producers.

   c. Serve the public interest.

2. Federal milk orders achieve their objectives by doing five things:

   a. Classify milk according to how it is used,

   b. Setting different prices for each class of milk (price discrimination),

   c. Pooling the proceeds from all uses of milk to all producers, and;

   d. Verifying the accuracy of reports of milk receipts and utilization.

   f. Serve the public interest by doing the above four things efficiently.

   The critical features of these activities that insure the effectiveness and equity of Federal milk orders is that they be applied universally and uniformly. Without

universality and uniformity, some participants in the market will enjoy competitive advantages over other participants that arise from regulatory laxity rather than from business accumen.

3. Historically, there have been only a few types of firms that have been exempted from the pooling and pricing provisions of milk orders. These include:

   a. Institutional milk processing plants, such as those operated by governmental institutions and universities,

   b. Small plants for which the administrative costs of regulation exceed the regulatory benefit,

   c. Plants located in Clark County, Nevada, and;

   d. Producer-handlers.

   Only plants located in Clark County, Nevada have a legal right to be exempted from regulation. The exemption of the other three types of plants has been permitted for administrative convenience, or to achieve a modest social objective. The idea that a typical dairy farmer should be able to enjoy a regulatory advantage in processing own milk has a measure of social appeal. The key work here is "typical". The expectation was, and I hope continues to be, that such an exemption would have a negligible effect on the other producers and handlers in the market who were fully subjected to the regulatory program.

4. An exempt plant, and in particular a producer-handler plant, enjoys a significant competitive advantage over other producers and other handlers in the market.

   As a producer, the exempt producer-handler can receive more than the blend price for his milk, depending on his internal transfer price between his plant and his milk production activity.

   As a handler, the exempt producer-handler may pay less than the Class I price for his milk supply, again depending on his internal transfer price between his plant and his milk production facility.

   Of course, if the producer-handler views his milk production activities and his milk processing and marketing activities as a single integrated enterprise, his profitability depends on all of his costs and all of his revenues.

   Nevertheless, the combination of these two activities, in the presence of regulatory exemption, gives the producer-handler a significant competitive advantage over his rival producers and handlers. This advantage is the difference between the local Class I price and the local blend price. A producer who participates in the Federal milk order pool receives the blend price for the milk he sells. A handler who is

regulated pays the Class I price for the milk he buys and uses in Class I products. In 2003 the difference between those two prices amounted to $1.03 in the Southeast order (Exhibit 41, p. 11), and $0.94 in the Appalachian order (Exhibit 10, p. 2). That gap is eliminated for a producer-handler who is exempt from regulation, and that amount of money is available to the producer-handler to create a competitive advantage for his business. As a result, a producer-handler represents a severe competitive problem for rival handlers and rival producers.

There are other sources of competitive advantage that the producer-handler may or may not be able to exploit. These might include efficiency in milk production, efficiency in milk processing and distribution, effective marketing, high quality, and better service. However, these sources of competitive advantage are equally available to the producer-handler and to his rival producers and handlers. They are not a consequence of regulatory privilege.

The competitive advantage arising from exemption from the pooling and pricing provisions of a milk order is a consequence of regulatory privilege, and is not a consequence of the skill, luck or effort employed by the producer-handler.

5. Other pool participants effectively subsidize the operations of a producer-handler. To the extent that he experiences a raw milk cost for his fluid milk products that is less than the local Class I price, the producer handler can use its financial advantage to offer lower prices or better service than his rival regulated handlers can. As a result, his rivals must reduce their selling prices or increase their service costs to maintain their business. This means reduced profits or increased losses to those rival firms.

   To the extent that a producer-handler, as a producer, experiences a raw milk selling price higher than the local blend price, his profits in milk production will be larger than those of his rival producers, and he can use these profits to acquire more and better resources than his rivals can.

In the long run, given equal skill, luck and effort, the producer-handler wins the competitive struggle with both his handler rivals and his producer rivals. All of this arises out of a regulatory artifact, and not out of the merit of the producer-handler business enterprise.

In effect, the producer-handler is able to extract significantly more from a particular market environment than can his rivals because he is exempt from the minimum pricing and pooling regulations of the order. The more he extracts means that the other firms extract less. This shows up most vividly in the form of reduced resale prices and profits for packaged fluid milk, in the reduced amount of producer milk classified as Class I in the market, and in the reduced blend price that accrues to other producers.

6. I stated earlier that the exemption of a processing firm from the pooling and pricing provisions of a milk order would be tolerable if it had a negligible effect on the other firms in the market, including producers and handlers, who were fully regulated. This raises the question of what is negligible and what is not.

   Based on my experience, I would assert that anything more that $0.01 per hundredweight reduction in the local blend price is not trivial. Dairy farmers, both individually and collectively, are very sensitive to differences in pay prices, even differences as small as $0.01.

   In the Southeast market a shift of about two million pounds of Class I sales per month between a fully regulated handler and any and all producer-handlers would change the blend price by about $0.01.

   A smaller shift of Class I sales between fully regulated handlers and producer-Handlers in the Appalachian market would cause a change of $0.01 per hundredweight in the blend price.

   For a regulated fluid milk processor under either of the two orders, a change in resale price of $0.005 per gallon would be significant. Mr. Hitchel of the Kroger Company testified to this amount, and Mr. Herbein stated that his clients gain and lose business based on $0.01 to $0.02 per gallon differences in resale prices. In 2003, the $1.03 difference between the Class I price and the blend price under the Southeast order represented $0.089 per gallon.

7. The question arises as to why there are not more, or bigger, producer-handlers if they enjoy such great advantages.

   The same question can be asked more generally as to why more resources do not move more rapidly into the more profitable activities in the general economy. The answer is that resources are sticky, and can not be quickly or easily shifted among alternative uses. However, there is great potential for both a larger number and larger sized producer-handlers in the future. The structure of milk production is changing rapidly in the United States, with more than a third of the milk produced of farms with more than 500 cows. These enterprises are large enough to gather the resources needed to set up a bottling operation and compete effectively in the market for fluid milk products. I don't believe that these are the kind of producers that the current producer-handler exemption is intended to protect.

   In addition, there is a high risk of regulatory change. An average, or larger, fluid milk processor, because of its size, can expect that if it sought producer- handler status for one of its plants, there would be an immediate legislative or regulatory change, and the plant would become fully regulated. This same risk does not seem to apply to existing producer-handlers who choose to expand their size and importance.

8. For what size of producer-handler is exemption tolerable? There is no definitive answer, but it is imperative to choose a fixed number. Fixed numerical standards are common and have been found to be necessary in all forms of regulation, including the tax code and environmental standards. Federal milk orders are no different in that an objective measure is needed to judge whether an individual or firm is or is not in compliance with the order.

   I offered one measure above, that the exemption of producer-handlers, collectively, could be based on the volume of Class I sales that would cause a $0.01 change in the blend price. In the Southeast order that would be about two million pounds per month. It would be a lesser amount in the Appalachian market.

   Another measure could be the average size of milk producers in the market. This measure would conform to the idea of a "typical" dairy farmer integrating into procession. In the Southeast market the average producer sells about 150,000 pounds of milk per month. So, a size limit for exempting producer-handlers could be set at about that level.

9. How relevant is the cost of milk production for a producer-handler? Obviously, it is important to him as it affects his profits, but is not important whether his costs are more or less than other producers in the market. The costs of milk production vary greatly from one producer to another as a result of differences in management and resources employed. The decision of whether to continue in milk production is based, in the short run, on whether all variable costs are paid. In the long run, the decision to produce milk depends on whether all costs of production are paid. As a result, when milk prices go up and down, most producers continue to produce milk because variable costs are being paid.

   For the market as a whole, the cost of production must be at, or below, the blend price. Otherwise, milk production would fall, and there would not be an adequate supply of milk for Class I use.

   If a producer-handler cannot survive paying the Class I price for his fluid milk supply, and receiving the blend price for his milk production, that means that he is less efficient in milk processing and distribution and/or in milk production than his rivals, and should be discouraged from continuing in the business. If he continues in business, there is a loss of economic efficiency, because other producers and regulated handlers are willing and able to provide the same goods and services at lower costs. Society benefits as a result.

10. Balancing is an important cost for the fluid milk market. Significant reserves of milk are needed to insure that sufficient milk is available for Class I use at all times. Each plant needs an operating reserve that covers unavoidable Class II, Class III and Class IV uses, such as shrinkage, and the disposition of cream arising out of standardizing Class I milk. In addition, a reserve is needed to cover seasonal

variations in Class I sales and milk production. In an average market, the minimum average of these two kinds of reserves is about 15 percent. The actual size of the reserve in a particular market depends on how much milk is pooled, and how many Class I sales are regulated. In 2003, the Class I utilization of producer milk in the Southeast market was 65.47 percent, meaning that 34.53 percent of pooled milk was reserve.

Reserve milk must be disposed of in lower valued uses. This is one of the reasons for classified pricing and pooling in Federal milk orders. The process of pooling insures that all producers share in the lower value of reserve milk.

Producer-handlers do not share in the cost of disposing of the market-wide reserve, but they do incur the cost of disposing of their own reserve. However, their reserve is likely to be much smaller than the market-wide reserve, and they may have opportunities to get higher prices than can be obtained for the market-wide reserve.

A producer-handler has a high degree of control over both the volume and variation in monthly milk production. For example, if he operates both a farm associated with a producer-handler enterprise and another, pooled, farm, he can shift cows back and forth to tailor his producer-handler milk supply to his Class I needs.

A pooled producer can control his own milk production, but he cannot control the volume or monthly variation of other producers in the market-wide pool. Therefore, a producer-handler is likely to experience an even smaller reserve than the minimum average of 15 percent mentioned above.

Also, a producer-handler may be able to sell his reserve milk in a nonpool Class I market, while a regulated handler cannot. So, the producer-handler may be able to get higher returns for whatever reserve milk he has than can a regulated handler.

Whatever costs a producer-handler does incur in balancing his milk supply against his Class I sales are no different in kind than the costs incurred by pool participants, but they are likely to be much smaller in degree.