

Testimony of Proponent Cooperatives

Southern Marketing Agency, Inc.

Milk Marketing Order Hearing

Docket No. AO-388-A15 and AO-366-A44; DA-03-11

Atlanta, Georgia

February 23, 2004

The issue of large unregulated producer handlers is very serious. If not corrected it has the potential to completely undermine the Federal Order system. Large unregulated producer handlers have a distinct competitive advantage that they will naturally move to exploit unless the provisions we offer are adopted. Regulated handlers will not be able to maintain market share and will force suppliers to reduce prices in order to maintain the viability of their operations. The problems we will outline are not an industry secret. The expansion of this "loophole" is growing rapidly. In some cases retailers have become sophisticated enough to understand the advantage and seem to be recruiting producer handlers for supply. Just as in the initial hearing in Phoenix, there are likely some individuals in this room today who are here to get "schooled" on how to exploit these provisions and to learn whether this loophole will be there in the future for them to exploit. The issue has even led to discussions in some portions of the US dairy marketplace to lower regulated prices in order to provide some competitive equity.

The drive to exploit this loophole is or will create organized, disorderly marketing. There would be no advantage to exploit without first an Order and then the

exemptions granted to producer handlers. In this case the nature of the provisions are causing disorderly marketing.

Legal Authority to Regulate Producer Handlers

There has been an undercurrent of discussion and activity attempting to establish the position that the Secretary has no legal authority to regulate producer handlers. The simple fact that we are at a Hearing announced by the Secretary and supported by the Departments' Office of General Counsel should be reason enough to dismiss this thought. It is our understanding that the Department will not go to a Hearing without a determination that the Hearing proposals could legally be adopted.

This issue has been thoroughly reviewed and briefed in prior hearings and decisions. We ^{SUPPORT} the conclusions so reached that the Secretary has any and all authority to regulate Producer Handlers in her efforts to provide for orderly marketing conditions.

Basic Position

Our reason for participating in this hearing can be summed by the Secretary's comments in 1989.

The purpose of the Federal Milk Marketing Orders is to establish orderly marketing conditions for producers who are the regular suppliers of milk. In its simplest terms, this is accomplished by establishing minimum prices for milk in accordance with its use and providing for the pooling or equal sharing of the proceeds from the sale of milk in all uses among all dairy farmers supplying the market.

Any time that milk is sold within a Federal order marketing area and such milk is not priced by the order, the ability of the order to maintain orderly and stable marketing conditions for milk may be impaired. When milk of a producer-handler is sold in a Federal milk marketing area, such milk is not priced by the order. In such case, the order does not provide uniform

regulated pricing among competing handlers since fully regulated handlers must pay the minimum order class I price for milk in fluid uses while producer-handlers are not required to do so. This raises the potential for competitive inequities among handlers. Furthermore, there is not an equal sharing among all dairy farmers in the market of the returns from the sale of all milk in all uses since producers whose milk is being priced under the order do not share in the Class I sales of producer-handlers.

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The key point is there are circumstances where the activity of producer-handlers can thwart the operations and intent of Federal Orders. For DFA members Federal Order provisions are a key component of their total marketing plans and when the Orders' ability to function as intended is impaired we are concerned.

We intend to demonstrate in support of our proposals that the operation of large producer handlers in both Orders 131 & 124 and in any other federal order:

- 1) Can draw sizable dollars out of the order's blend price pool thus not allowing for an equal sharing of the Class I revenues generated by the operation of the Order for all regular suppliers to the market;**
- 2) Have serious competitive impacts on handler equity causing a loss of sales to fully regulated handlers;**
- 3) Have the ability to service multiple retail accounts thus impacting competitive pricing in the market;**
- 4) Have balancing costs that are a small percentage of the advantage offered by avoiding class prices.**
- 5) Are larger in some cases than many of the regulated handlers in the Federal Order system;**
- 6) Are statistical outliers in terms of size in the Federal Order system and that our proposal will have no impact on the current operational ability of nearly all of the producer handler operations in the Federal Order system; and**

- 7) Have economies of scale on the fluid milk processing portion of their business and in the area of costs of milk production that have the potential to generate significant revenue streams that can be used to capture market share from other regulated handlers.

Impacts to the Producer Blend Pool from the Order 131 Experience

When producer handler Class I revenues are not shared with the market wide pool, dollars are lost to the remaining producers in the Order. Since exact producer handler data is restricted from publication by Federal Order 131 for confidentiality reasons, we can only make inferences to their exact volumes. But in a published table by the Order 131 Market Administrator titled *Class I In Area Routes by Pool Plants, Producer Handlers and Other Plants Arizona Las Vegas Order (FO 131) January 2000 through June 2003* (Exhibit 6 – Table ^I1) there is enough detail to make a reasoned estimate that Producer Handlers account for 12.8 to 19.1 million pounds of Class I In Area Route Sales. (last number published without producer handlers subtracted from the high/low month with producer handlers) The difference between the monthly totals for February and March of 2001 represents the volumes of producer handlers in the marketplace and from other Order plants. Based on our knowledge of market conditions and of producer handler operations in the market we believe that large producer handlers represent the majority of the volume difference. The revenues from the sales, to the extent they are from producer handlers, are not shared with other producers in the pool.

When these sales are priced on a component basis and adjusted for location they result in a reduction in producer funds of \$0.05 to \$0.29 cents per hundredweight. For the 43-month period measured the average reduction is approximately 12.5 cents or based on an average monthly pool of 254 million pounds – \$317,000 per month. We consider that sum significant. It seems unreasonable that the actions of

primarily a single entity could cost all producers in the marketwide pool \$317,000 per month. (Exhibit ^{61, TABLE J} 9 - *Federal Order Estimated 131 Blend Price Calculation Possible Effect of an Additional 18,000,000 Pounds of Producer Milk in Class I at Market Average Class I Butterfat at Test and \$2.10 Class I Location Adjustment.*)

Impact to the Competitive Relationships Between Processors and Retailers

The starting point for the measure of impact is the comparison that the regulated handler pays class prices for the milk used in his plant but the producer handler accounts to their operation at the blend price. The table *Comparison of Class I and Blend Price Federal Orders 1005 CY 2000 – 2003* (Exhibit 61- A1) (Table A2 shows similar comparisons for Order 1007) detail this difference. The annual averages, when expressed in cents per hundredweight range from \$0.68 - \$1.03 or on a per gallon basis from \$0.059 - \$0.089. For a business that makes bids based on multiple decimal points, this difference equates to a sizable and significant competitive advantage. Testimony by various processors here will further detail the competitive strains caused by this sizable price difference. However, the point to remember is that Order provisions that allow large-sized producer handlers to avoid regulation but still compete with regulated handlers in the marketplace cause disorderly marketing issues.

Processors face competitive challenges on several fronts. Testimony from processors will provide further detail but I would like to characterize several from my own experience in marketing bulk milk to processors. Milk marketing and pricing is a process of continual negotiation. Day to day changes in market conditions always call for a new look at prices. If my processing customer faces new competition from their competitor they will always ask about the price – and how they can get a lower one. Milk from producer handlers can be and is used by retailers to “leverage” their supplier for a lower price and to stay competitive

themselves. Usually the “lowest price” puts pressure on every other price. To get some idea of the pervasiveness of the ability to put downward pressure on prices we have developed two tables.

Exhibit ^{Table} 61 - B *Ability to Service Retail Accounts by Size of Processor* uses several calculations to arrive at relating the volume of milk packaged by a handler to the common unit of delivery – a trailer load. We show this calculation for a variety of sizes from 30 million pounds per month of processing capacity down to 100,000 pounds. The top end of our table would encompass the largest processing plants in the US and the smaller end would encompass the majority of producer handlers in operation today.

The volume limitation measure we have proposed – 3,000,000 pounds per month is still sizable. It would allow the producer handler to deliver 2.5 trailer loads of gallon jugs of milk to a single or combination of retail accounts per day. This volume would be enough to cause a significant competitive reaction in the marketplace. A retail chain of several stores in a nearby suburb market with pricing driven by the gap in the producer handler price versus the regulated handler price would get the attention of the remaining retailers in the market. They would be sophisticated enough to know whether the marketing strategy of that store (or chain) was driven by “every day low price” or a random promotion as a loss leader. If the strategy were not a very temporary “loss leader”, they would press their milk supplier for a reduced milk price in order to compete. Milk is a major category for retail sales because it is a rapid turnover item. A retailer must be competitive on milk prices in order to stay in business.

We attempted to quantify the number of stores that might be serviced by the 3,000,000 pound per month producer handler by contracting with Institutional Resources Incorporated to provide us data on milk sales per store. They have store universe of 12,800 stores representing approximately 80 – 90 percent of the universe of US grocery stores. This population does not include super stores or club

stores, drug stores selling food or convenience stores. From this population they provided data on 3,200 stores that represented the smallest 25% of their store sample. (Stores are stratified based on total sales receipts of all commodities.) The average store in this subset (the smallest 25%) sold 1,070 gallons of white milk per week. At the ratio of 4,500 gallons per trailer the 3,000,000 pound per month producer handler could service 74 stores per week with gallons. $(4,500/1,070*2.5*7)$

Using the remainder of the universe of stores, in this case the largest 75% of the population, the average store sold 4,425 gallons per week. The 3,000,000-pound per month producer handler could service 18 stores of this size per week. The stores that make up this subset could easily be a metropolitan retail grocery chain with a reasonable market share. In both cases, a competitive problem is caused by exploiting the price difference allowed by the lack of regulation of the large producer handler. In our experience when this occurs the bottling plants which we sell raw milk to face tremendous "bottom line" pressure and ask us for price reductions. This situation is quantified by Mr. Herbein's exhibits.

One rationale given for not regulating producer handlers is that they have costs that absorb any potential gain from not paying regulated prices. This argument has been offered extensively in previous hearings.

The cost arguments seem to be premised on two points: – that operational costs and balancing costs of producer handlers are greater than for regulated handlers, and that this justifies ignoring what would otherwise be a significant competitive advantage. There will be evidence at this hearing that producer handlers over 3,000,000 pounds per month do not suffer significantly lower operational or balancing costs than the regulated handlers of the same or larger size.

Mr. Herbein's exhibits detail the fallacy of these arguments from the standpoint of operational costs. In the Exhibit 57 - *Cost Structure of Fluid Milk Plants of*

Various Sizes he detailed the cost for operating plants of various sizes. For the size plant that most approximates the majority of producer handlers – the 90,000 pound per month monthly volume the argument that costs absorb the benefit seems to hold true. That plant size details an “operating cost only” of \$1.008 per gallon or approximately 40 cents more per gallon than the costs for the plants within the range that we propose ending the producer handler exemption. The price per gallon advantage gained between the blend and Class I prices (as noted previously) is more than eliminated by the cost differences between the normal sized producer handler and the next closest, smallest sized larger processor. As shown in the Herbein data the cost “spread between what Mr. Herbein identifies as the “C plant” (which most closely approximates the average fluid milk processing plant in the US) and a “D plant” (which approximates the expected size of the Sarah Farms plant) are reasonably close. No logical argument could be made that a producer handler larger than the average sized Federal Order processing plant needs an exemption so that he can compete. Nor should a smaller sized producer handler (between our proposed 3,000,000 pound per month limit and the average sized Federal Order plant), as shown in the Exhibit, need an exemption to compete with smaller regulated plants.

Furthermore, in keeping with marginal economic principles, the cost curve flattens out as volume grows. So the larger plant can add volume at little additional cost. A large producer handler who does not pay regulated prices, would easily be able to gain market share at will. This seems to describe the retail market scenario in Order 131, and is the concern in Order 7 and 5 as well. This would be an example of disorderly marketing, as I will discuss further in my testimony later.

Mr. Herbein’s exhibits further develop the principle that a regulated handler cannot service a segment of the market, known to be regularly supplied by producer handlers, – if he must pay the full regulated price. Exhibit ⁵⁷28 - E titled *Comparative Analysis of Returns to Producer Handlers and Regulated Distributing Plants Supplying a Warehouse Store* demonstrates that for the superstore/club store

category using industry derived data, a handler paying regulated prices cannot service the store with any return or with a return so minimal that he could not remain in business. This Exhibit does not allow any "profit" for the processor and still does not show a viable return. Equally concerning is that the return for the producer handler is substantial and viable. Certainly this data speaks to the issue of "inequity of handler prices".

Additionally, this Exhibit contains no values for premiums, a fact which SMA member cooperatives have an interest in. With no premium value the producer pays for all of the market servicing costs and further depresses producer returns. If our customers can't be profitable – then neither can SMA member cooperatives and their member dairy farmers.

The remaining five exhibits (Exhibit ⁵⁷ 25 G - K) detail similar comparisons for the five size ranged processors we reviewed earlier. All would lose money paying regulated prices and servicing this type of account at the prevailing prices in the retail market. In fact it would take a producer handler bigger than "C" to perhaps break even for this business. But if the large producer handler can earn a return and grow his business – pressure to terminate the Orders will be impossible to resist. The processor will either demand a lower price (until he bumps into the minimum price) or seek a similar producer handler arrangement. Producers will see a smaller and smaller share of the Class I sales in the pool and conclude that the concept is no longer working and seek to terminate orders to preserve some level of market share. Once the Order is terminated the "advantage" to the producer handler is eliminated, all market participants are at lower prices and the benefits of the Order are gone.

The line of argument for defending the producer handler exemption from the position of additional and excessive balancing costs does not bear up either. Exhibit 61 ^{Tables} C1 - C2 titled *Estimated Impact of Balancing Surplus Milk for a Producer Handler at Varying Utilization Percentages Order 1005 & 1007* depicts the

alternative returns from balancing the producer handler supply at a plant utilization of 90% Class I.

The exhibit computes a "Producer Handler Blend" (a full description of the table was given when the Exhibit was introduced) taking into account the producer butterfat test, the Class I butterfat test, pricing the producer handler components sold to Class I at the Uniform Component prices and the volume to be balanced at the lower of Class III or IV and comparing the resulting value to the announced Uniform price at test.

At a 90% Class I utilization the comparison of the Producer Handler blend to Uniform blend resulted in a lower return of 28 to 35 cents per hundredweight or about a 2³/₄ cents per gallon. The balancing cost still allows for the producer handler to take advantage of the difference between the blend price and the Class I price.

A regulated handler has premium charges reflecting the cost of balancing. Additionally most producer handlers have their processing plant very near or at their farm supply so that they do not have the cost to assemble and transport milk to the market.

Furthermore, a portion of the producer handler's balancing costs can be shifted to the entire pool when they sell surplus to regulated handlers and when the retail outlets they serve order additional (or reduce orders of) packaged products. The Order allocation provisions attempt to reduce the effect of producer handler balancing on sales to distributing plants by down allocating the receipt and if a portion of the supply gets allocated to Class I a compensatory payment is charged. However, there is no compensation for lost premium dollars or reduced return when regular suppliers' milk is pushed into manufacturing plants that result in lower returns. Typically the producer handler surplus follows the typical market patterns and would surge milk into the pool in the lowest return period for the

market's balancing plants. Additionally retailers will fluctuate their orders to keep shelf space stable and add volumes from the non producer handler processors that are supplied by the pooled producers.

To summarize this point – the producer handler has balancing costs – they are a given in the milk business. But from our example the difference between the producer handler “uniform” price, which takes into account his utilization, and the marketwide uniform price is minimal when compared to the advantage gained from not paying the class price. Secondly the costs he may have are offset by the very tangible premiums paid by regulated handlers and the real but difficult to estimate savings of pushing surplus back on to the marketwide pools regular suppliers by selling surplus to regulated handlers and balancing supplied by retail customers. Also the producer handler has operational costs but only the very small – but more typically sized producer handler has cost that are above the range of the market. The large sized producer handler has operational costs that are lower than the averaged sized Federal Order regulated plant. No valid argument can be made that an exemption from the regulated price is warranted from either of these two arguments.

The Relative Size of Large Producer Handlers as Processors and Farms

A common defense of the existing treatment for producer handlers under the Order is that they are small businesses that need the additional benefit that the current provisions offer them and that they are small enough to not be an impact in the market and that the cost of regulation would be greater than the gain from regulation.

There are only a few producer handlers in the whole country larger than the limit we propose for change in the regulation. Data from all Federal Orders strongly support this conclusion. Exhibit 6.1 D - *Data Relative to Producer Handlers in Orders 5 & 7* shows our estimate of the volumes of milk associated with the

Producer Handlers in Orders 5 & 7. We derived these estimates from our own sources. Clearly any producer handler with milk production in excess of 3,000,000 pounds of monthly production is well beyond the "small" label. Our estimate corroborates those made by United Dairymen of Arizona in its' testimony.

Exhibit 61 E - *Recap of Producer Handler and Exempt Plants Data All Federal Orders May 2003* summarizes information relative to Class I volume at producer handlers and exempt plants from all Federal Orders for the month of May 2003. (For the purposes of discussing this exhibit all references will be to both producer handlers and exempt plants.) Based on the information we obtained there are at least 101 producer handlers in the Federal Order system. A count of the names published in other statistical summaries would add 17 more to the total.

The average Class I volume for which we have data is 587,721 pounds per month. From what we know from at least two of the markets with restricted data the Order 5 producer handlers are small and two of the three Order 131 plants are also small. DFA's competitive information about six of the 13 Order 33 producer handler plants would also be below this average. The median size of producer handlers for which we have data is 96,807 pounds per month. While only three Orders were able to provide this data they represent the majority of the producer handler plants. The information we have from other Orders not able to publish data would substantiate this figure. The detail that is available relative to size by grouping continues to support the conclusion that large producer handlers are not the norm for the Order system. For those Orders that reported size groupings the largest one third (or half in the case of Order 126) was consistently very much larger than the remainder. Giving credence to the thought that the largest group was indeed very large. The same tendency is displayed in the percentage of the market's Class I sales, where the largest group dwarfs the smaller grouping's market share.

Exhibit 61 G/H - *Recap of All 7(a) Plant Data All Federal Orders May 2003* detail an identical table as above for the Class I volume at 7(a) Federal Order distributing

plants. The 278 listed Federal Order regulated plants have an average volume of 14,849,743 pounds. The median sized plant volume is just below 12,000,000 pounds. In the two smaller size groupings the average plant volume is 3.7 and 11.4 million pounds per month respectively.

In the experience of Federal Order 131, the largest producer handler in the US, Sarah Farms is larger than the average sized plant in either of the two smaller sized groupings, which would contain more than 2/3 of all Federal Order distributing plants. From DFA's investigation it is the largest producer handler in the US. Quite likely it is at least double the size of every other producer handler except one and in several cases would be larger than the collective production of all of the producer handlers of some Orders.

It seems invalid to make the argument that a plant of this size needs the exemption granted to producer handlers. There can be no reasonable argument why 2/3 of all Federal Order plants should pay regulated prices and plants of this size should not.

Furthermore the regulated plants in the smaller 2/3 grouping would face the same unfair and difficult competitive situation when trying to compete with producer handler larger than the typical size but smaller than Sarah Farms. All of the arguments we have offered would support this conclusion. The size versus competition factor helps us in selecting the 3,000,000-pound per month limit for granting the exemption from paying regulated prices. We also note that at the 3,000,000 pound threshold the plant volume would be near the average of the smallest 1/3 grouping for all Federal Order plants. Its continued operation as a producer handler would put it in a very favorable competitive position with non producer handlers of that size – several of which operate in the Order 5 & 7 marketing area.

In addition to being a statistical outlier in terms of plant operations the large size producer handler would also be an outlier in terms of farm size. According to *Producer Structure in Federal Milk Orders, May 2001* ^{Ex 62} (Official Notice) farms of over 2.5 million pounds compose 0.6% of all farms pooled on Federal Orders. Whether these operations are family farms, or some other type of corporate ownership it does not seem reasonable that they be granted special exemption from the Order's pricing provisions.

Finally, large farms have significant economies of scale with regard to the cost of the cost of milk production. The significance of this factor is that they have resources available to them that they may be able to use to affect the marketplace that smaller producer/producer handlers would not have.

According to the *Agriculture Income and Finance Outlook September 2002* (Official Notice - ERS Report AIS-79) ^{Ex 63} page 39, Industrial – Large-scale dairy farms (500 cows or more) have an average cost of operating and ownership of \$10.46 per hundredweight versus \$15.81 for the small (less than 50 cows) and medium sized \$13.47 for medium sized operations. This difference \$3.01 to \$5.35 per hundredweight is larger than even the cost of avoiding minimum order prices, and could be used to gain market share. This is another reason to limit the producer handler pricing exemption to farms with less than 3,000,000 pounds of milk per month.

Order Language

SMA supports the language in Proposal 7 and offers the following comments about the proposed language changes to the current order language.

Proposal 7 would first amend § ^{1007.10}1005.10 to add:

§ 1007.10 Producer-handler.

(e) has route disposition and transfers in the form of packaged fluid milk products to other distributing plants during the month that does not exceed 3 million pounds;

From the outset our intention is that if a person desires to be a producer handler and gain exemption from the pricing provisions of the Order, the standards they must meet, must be strict and clear. Having route disposition in the marketing area gets a producer handler regulated if he has route dispositions or transfers of fluid milk products to other distributing plants anywhere in excess of three million pounds. We do not want to see a scenario where someone attempts to gain producer handler status by splitting their sales into several markets to avoid having some determining percentage in Order 5 and 7.

2. Proposal 7 also adds the following:

Amend 1007.10 to add the following:

(f) The producer-handler does not distribute fluid milk products to a wholesale customer who is served by a plant described in § ¹⁰⁰⁷1005.7(a), (b), or (e), or a handler described in § 1000.8(c) that supplied the same product in the same-sized package with a similar label to a wholesale customer during the month.

This language is currently a part of Order 131 and we would propose it for Orders 5 and 7 as well. It prevents a producer handler from "striking a deal" with or through a retailer to provide balancing by packaging product in the producer handler's label in the same size container when the producer handler is unable to do so. If this were to occur the pool's regular suppliers would ultimately balance the surplus of the producer handler. Note that we would expect this comparison to be made for an entire chain of stores and not an individual store in a chain.

Summary

The competitive situation that large unregulated producer-handlers create is one of disorderly marketing conditions. What started out as an "exemption" to producer handlers because they were not a competitive factor in the market, has evolved into a new competitive situation that threatens to undermine the entire Federal Order system. For these reasons SMA proponent cooperatives support a limit to the producer handler exemption for producer handlers who are larger than 3,000,000 pounds of Class I sales per month.

Producer handlers larger than this size can draw considerable sums of money out of the blend pool thus creating inequity between them and the regular suppliers of the pool. They have a cost advantage to exploit, the difference between the blend price and the Class I price and they may do so aggressively. The traditional arguments supporting the exemption have been shown to be faulty:

- 1) they do not suffer a disadvantage in the area of competitive operational costs;**
- 2) they do not suffer a disadvantage of significant proportion in balancing their operation – and have some abilities to push those costs over to the other producers in the pool;**
- 3) they are of significant size and as such are “statistical outliers” in the overall population of producers and handlers in the federal order system and have a sizable share of Class I sales in both markets;**
- 4) they cause market disruption to the extent that both processors and producers could ultimately be forced to seek relief by the elimination of the Order.**

These factors surely are signs of disorderly marketing.

The language we propose will maintain the producer handler option for over 99% of the producers in the Order system - far from a total elimination of

the exemption. It continues to “allow for a startup” if a dairy farmer wishes to become a producer handler. It allows for that avenue of enterprise to continue – up to the point where the producer handler should face competition in the marketplace on the same terms as other handlers.

It helps assure that all regulated handlers (both large, medium sized and small) face the same minimum costs. And it provides some language changes to make the regulation of producer handlers more clear. It is not possible to justify the continued exemption in its’ current form. The producer handler exemption threshold should be based not on how inefficient the producer handler operation is – thus needing a price break – but rather how disruptive they are in the marketplace and how much they contribute to disorderly marketing.

The 3,000,000-pound limit we propose:

- 1) Is consistent with the limit set by Congress when establishing the processor promotion payment program when it decided that threshold was sufficient for a processor to afford the cost and realize benefits from the program;**
- 2) Is a point on an operational cost curve where the higher costs due to small scale become absorbed by larger volumes and any competitive disadvantage of the producer handler evaporates;**

- 3) Is a point based on actual retail sales data where a processor can service enough retail accounts to have an impact on competitive factors in the marketplace;**
- 4) Is a point where significant advantages in the cost of producing milk can be achieved and used to subsidize the gain of market share in the retail food business; and**
- 5) Is a point where economies of scale in fluid milk processing are clearly evident.**

We request timely and decisive actions by the Secretary in response to our proposal.