Lone Star Milk Producers

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FEDERAL ORDER TRANSPORTATION CREDIT HEARING
APPALACHIAN and SOUTHEAST ORDERS

Docket Numbers AO-388-A17 and AO-366-A46; DA-05-06

Hearing Clerk, STOP 9200-Room 1031
United States Department of Agriculture
1400 Independence Avenue, SW
Washington, DC 20250 - 9200

Brief on Behalf of Lone Star Milk Producers, Inc.

Lone Star Milk Producers, Inc. (hereafter Lone Star) supports Proposals Number 1, Number 2 and Number 3 as included in the Notice of Hearing, Milk in the Appalachian and Southeast Marketing Areas, Docket Numbers AO-388-A17 and AO-366-A46; DA-05-06. Lone Star opposes Proposals Number 4 and Number 5 as included in the Notice of Hearing.

In support of Proposals Numbers 1, 2 and 3, Lone Star makes the following points:

As a supplier of milk produced both within the Order 1005 and 1007 marketing areas and supplemental milk produced outside the two marketing areas, Lone Star is acutely aware of increases in the cost of transporting milk. The data submitted at the hearing regarding costs of hauling represent the kinds of increases Lone Star has seen in the recent past in hauling costs.

The hauling cost factor which was used to develop the mileage rate used in the Orders for the Transportation Credit balancing Fund payments is terribly inadequate, since it has not been updated since the middle 1990's. All costs associated with hauling milk have increased since that time. Fuel costs, as demonstrated in the hearing record, are perhaps the most notable and visible cost factor. The current rate of reimbursement used in Section 82 of the two Orders provides a rate of $0.00350 per hundredweight per mile. Data introduced at the hearing show the current rate to be more in the range of $0.00475 to $0.00500, and Lone Star currently experiences costs of hauling in this range.

Lone Star has for several years received payments from the Transportation Credit Balancing Funds of Orders 5 & 7 for supplemental milk deliveries to Order 5 & 7 Class I plants. In the late 1990's these payments represented in excess of ninety percent of the actual cost of moving Class I milk

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from outside the Orders to inside the orders. We now find that the real rate of reimbursement of the cost of Class I milk to be more like 35 to 40 percent of the real cost.

The reduction in the real rate of reimbursement from the Transportation Credit Balancing Funds comes from an outdated mileage rate and the proration of payments by the market administrators due to insufficient funds in the Transportation Credit Balancing Funds. Lone Star supports Proposals Number 1 and 3, which would increase the assessment rate on Class I milk to fund the Transportation Credit Balancing Funds, and to establish an updated mileage rate for making payment from the Funds.

Lone Star supports the language included in Proposal Number 3, without further modification. As was demonstrated at the hearing, the actual costs of moving Class I milk covered by the Transportation Credit Balancing Fund payments in the mid 1990's totaled approximately 95 percent of the true cost. The mileage rate as provided in proposal 3, even after adjusting for current fuel costs will be less than 95 percent of the actual cost of hauling. No further adjustment of the mileage rate is necessary.

Lone Star supports the use of the U.S. Department of Energy, Energy Information Administration weekly diesel fuel prices as provided in Proposal Number 3. The fuel adjustment mechanism as proposed is fair, transparent, and mirrors fuel adjusters used in industry.

For several years the Transportation Credit Balancing Funds have been under-funded, and this shows itself in the fact that the market administrators seem to begin prorating payments from the Funds earlier and earlier each year. The Secretary should set the assessment rate for the Transportation Credit Balancing Funds at a level great enough to pay all of the anticipated claims, and at the higher mileage rate as proposed.

We challenge the Secretary to return the functioning of the Transportation Credit Balancing Funds in the Appalachian and Southeast Orders to the process and level which existed when the Transportation Credit Balancing Funds were first established. Lone Star agrees that the three cent increase in the assessments which went into effect November 2005 will likely not be enough to fund 2006 claims against the Transportation Credit Balancing Funds, even at the current mileage rate. An increase in the Fund Assessments are necessary, warranted and long needed.

The location of supplemental supplies relative to the two marketing areas creates differences in costs of supplying supplemental milk to the two Orders. Milk must move greater distances to supply the Southeast Order marketing area than to supply the Appalachian Order marketing area. For this reason, a difference in the rate of assessment between the two Orders to fund the Transportation Credit Balancing Funds is justified.

Differences between the two Orders in the true effective rates of assessment on Class I milk for the Transportation Credit Balancing Funds have existed in the past. In 2003 and 2004 the market administrator for the Appalachian Order to waived the Transportation Credit Balancing Funds assessment for two months each year, while the market administrator for Order 7 did not waive the assessment. These action resulting in real effective differences in the rate of assessment on Class I milk.

One of the numerous benefits of having the Transportation Credit Balancing Fund process under the Orders is the assurance to the industry and the consuming public that the work paid for is work which is actually done. No payments are made from the Transportation Credit Balancing Funds unless the producers are supplemental to the Order, the milk actually moved, and the milk was utilized in Class I.

Another hallmark of Federal Order, which is demonstrated in the Transportation Credit Balancing Fund process is assurance that the Class I costs are applied uniformly to all plants. Continuing the Transportation Credit Balancing Fund process is a must in assuring equity in the distribution of these costs, and the continued application of the costs onto the Class I marketplace.

Lone Star has witnessed the loss of dairy farms and processing plants in the southeast. Milk must move increasing distances every day because there are fewer farms and fewer plants for the milk to go to. These increased distances have created inequities in the distribution of costs of supplying milk to Class I plants. Just as the Transportation Credit Balancing Funds process is not sufficient to move milk from outside the marketing areas, the Class I differential surface is insufficient to move milk within the marketing areas. Lone Star therefore supports the establishment of a new Intra-market Transportation Credit Fund under the Orders.

Lone Star, just like some other marketers of milk, has significant volumes of milk which cannot be delivered to the nearest Class I plant because the milk produced near those plants exceeds the plant's needs. When this happens, the milk must move to more distant plants and the Federal Order location adjustment structure does not cover enough of the incremental cost of moving milk. Producers end up footing the bill, in a way not envisioned in the Class I price and location adjustment structure. Proposal number 2 seeks to provide a tweak to the location adjustment process which will offer incentives to move milk within the marketing areas, while not disturbing the current location adjustment relationships.

Proposal number 2 offers a compromise solution between the large scale project of revamping the Class I price surface and the need for Order price differences sufficient to encourage milk to move from areas of production to areas of Class I processing. If the assessment established to fund the Intra-Market Transportation Credit is sufficient to cover the claimed Intra-Market Transportation Credits the impact on producer blend prices will be less than if the Class I differential surface were re-aligned. This is true because there would be no payment from the Intra-Market Transportation Credit fund on the Class II, III and IV producer milk which moves past a producer's nearest plant, while producer milk delivered to a higher priced zone reduces the Order Uniform Price because the location adjustment is applied to all milk delivered, not just Class I.

Lone Star supports setting the Intra-Market Transportation Credit assessment at rates necessary to fund the anticipated credits, however, Lone Star also supports the proposed mechanism for using funds from the producer revenue pool if the assessments are insufficient to cover the Intra-Market Transportation Credit claims. Fairness in the allocation of the additional costs of getting milk to Class I plants which the Intra-Market Transportation Credit would address demands that the costs be covered in an equitable manner. Since all producers share in all of the Class I revenues generated at all of the Class I plants through the producer revenue pool, all producers also should equitably bear the costs of getting the milk to those Class I plants.

<u>In opposition to Proposals Numbers 4 and 5, Lone Star makes the following points:</u>

Testimony presented at the hearing demonstrated absolutely that the amount of milk pooled on the Appalachian and Southeast Orders was the amount necessary to supply the Class I needs of the

Orders and provide a reasonable reserve. There is no need to limit Transportation Credit Balancing Fund payments based on an arbitrary or capricious view of reasonable supply and or Order reserve.

As was more than adequately demonstrated at the hearing, the process proposed in Proposal 4 is in great need of clarification. Lone Star is at a loss to understand how the proposed language would really work. Would the "reserve" percentage proposed in Proposal 4 calculation be plant specific, be handler specific, and / or would it be cooperative specific? Could a handler place responsibility for its balancing reserve on a cooperative supplier, but then garner a 100% Transportation Credit Balancing Fund payment if it procured additional supplemental milk on its own? Could a multi-plant handler through the pool-reporting process place its diverted reserve supplies on one plant's report so that it could receive a greater percentage payout from the Transportation Credit Balancing Fund on supplemental milk received at another one of its plants? These and other operational questions must be answered and Order provisions solidified before industry can begin to adequately assess the impact of the proposal.

Furthermore, the "one-size-fits-all-reserve-requirement" parentages as proposed by the Proponents of Proposal 4 were not demonstrated to be appropriate. A handler's preferred reserve requirement is an individual matter, based on that handler's choices of method of supply, location of supply, a plant's customer base, the seasonality of the plant's customer base demand, the seasonality of the plant's producer supply, and risk preference.

Orders 5 and 7 already contain diversion limits and producer touch base requirements which are two of the tightest in the Order system. Diversion limits, producer touch base requirements, and pool plant qualification provisions are the right place in an Order to determine the amount of milk which can rightly be associated with the Order. Limiting Transportation Credit Balancing Fund payments to a handler (using some method truly yet undefined) is not the proper process.

Class I demand in the southeast is greatest relative to available milk production in the late summer and early fall months, which is no new phenomenon, nor is it any great secret. In order to attract an adequate supply for these orders in the critically short supply months, supply arrangements must be made year around. Further exacerbating this problem is producer seasonality in the southeast which is the greatest in the country. Put another way, no where else in the U.S. is the swing from high milk production months to low production months as great as in the southeast. Order provisions provide no regulatory method or economic signal to discourage this problem of seasonality of milk production.

In order to insure that milk is available to cover Class I sales in the tight production months, simply put, there is an over supply in the spring. Logistics and good business practice dictates that the furthest milk away from the marketing area is the last milk brought in to service the Class I needs of the Order. These distant producers are no less important in serving the Class I needs of the Order than producers located within the marketing area, it's just that these producer's milk is called on last.

Annually, milk from outside the two marketing areas represents almost one half of the supply of producer milk for the Orders. Without this out-of-area milk Class I plants in the southeast would not receive an adequate supply of milk.

Every producer pooled on the Appalachian or Southeast orders must meet the monthly touch-base requirement for pooling, by virtue of delivery to a pool plant. No producer can be pooled who has not delivered the requisite number of day's production to a pool plant. It is a very important fact, and it should be noted that all pool plants regulated by the Appalachian or Southeast orders are located within the marketing areas. So, no producer' milk can be pooled without that producer's milk having been delivered to a plant inside the marketing area – every month.

It is patently unfair to provide a system which would penalize a producer for delivery to a plant outside the marketing area, when that producer has physically delivered milk to plants inside the marketing area, and the producer represents a vital source of milk for the Class I needs of the Order. It's just plain not right. Establishing a price penalty on out-of-area milk deliveries is what Proposal 5 seeks to do.

These out-of-marketing area producers can be quite distant from the southeast. A producer located in Portales, New Mexico, an important reserve supply area for the southeast, must move their milk more than 550 miles to deliver to the nearest pool plant in Order 7. At current hauling costs it takes more than $1,250.00 to send a load of milk from Portales to Ft. Smith Arkansas, the nearest pool plant, which represents more than $2.65 per hundredweight, which is substantially greater than the difference between the Order 126 blend price at Portales and the Order 7 blend price applicable at Ft. Smith. Bringing this milk to the southeast when it is not needed for Class I use is clearly a money losing proposition. Consequently, this is some of the last milk to be brought into the marketing area to service Class I needs. Frankly, if the milk were able to be moved on the blend price differences, someone would be squawking about the Orders encouraging uneconomic movements of milk, or that the milk-source area was being placed at a competitive disadvantage because the neighboring Order can bid away local milk. Here in lies the conundrum.

Proponents of Proposal 5 have grossly mischaracterized the intent and operation of the old mileage-based "zone outs" which existed in the Orders prior to Order Reform. It is true that the mileage based zone –outs were used to compute the location value of diverted milk, but the section of the Order where these provisions resided also established the Class I price for pool plants located outside the marketing areas. The zone-out rates were designed to be aligned closely with the "zone-in" rates. For example, the difference between Montgomery and Birmingham in the old Order 1093, Alabama-West Florida pre-1985 Farm Bill was $0.15 per hundredweight. Montgomery and Birmingham are about 90 to 100 miles apart, so the difference in Class I prices was based on roughly $0.015 per ten miles. The zone out rate specified in Order 1093 was $0.015 per ten miles from a north Alabama basing point. At that time, the difference between Eau Claire, Wisconsin and the southern basing point cities of Atlanta and Birmingham was also about $0.015 per ten miles. So, the mileage zone outs were based on relative relationship which already existed in Class I prices. The system was not perfect and generated some differences in Class I prices for neighboring plants regulated on two different Orders, but the prices were fairly close. The Secretary certainly had no desire to install a pricing by location structure which substantially favored one plant versus another.

After the 1985 Farm Bill Class I prices were realigned, and the price relationships between basing points reflected a difference of approximately 2.5 cents per ten miles. The Orders were amended so that the zone-out rates for out-of-area plants (and by reference out-of-area diversions) reflected these new price relationships, that is, a zone at rate of $0.025 per ten miles or fraction thereof.

Proposal number 5 seeks to have a "zone out" rate which is more than twice the approximate "zone in" rate. Relating Proposal 5 to what existed prior to Order reform simply is an incorrect characterization of the previous location adjustment zone-out and zone-in process.

What the Secretary did in Reform was make process clean and consistent. Rather than have the "near-sameness" by location which came from mileage based zone out rates which approximated the mileage factor used in establishing the Class I surface (the zone-in rate), the Secretary just make location adjustments equal to the Class I price differences. Characterizing the reform process which uses Class I surface differences as a major change in determining location adjustments is not true. The reform just got the occasional messiness out of the process which came from using mileages versus fixed defined zones.

The Proponents of Proposal 5 seem to make the argument that in the "old days" the mileage based zone out rates for diverted milk were designed to create a disincentive to divert milk to out-of-area plants. While this could on occasion be such a consequence, it was not the intended purpose. If such were the case, it was an inadvertent result of imperfections in the mileage rate zone out price versus the differences in plant prices established under a zone structure. It was also true that these imperfections gave rise to beneficial treatment of certain out of area diversion. Both cases led to uneconomic movements of milk.

In regards to the other effects of Proposal 5, it was demonstrated unequivocally in the hearing testimony that Proposal 5 could lead to uneconomic movements of milk, and could encourage the uneconomic use of out-of-marketing-area pool supply plants.

For the above reasons, as well as others enumerated in direct testimony, Proposals Numbers 4 and 5 should not be adopted.

<u>Summary</u>

In summary, Lone Star Milk Producers, Inc. supports proposals Numbers 1, 2 and 3 because the proposals would return the reimbursement of costs of hauling supplemental milk into the southeast to the levels originally set by the Secretary when the Transportation Credit Balancing Funds were initially installed in the Orders; the establishment of a fuel cost based mileage rate would help keep hauling costs current; the installation of an Intra-market Transportation Credit would partially correct inadequacies in the producer location adjustment surface thereby providing equity in the allocation of costs of delivery to pool distributing plants; and would assign to the Class I marketplace and Class I consumers the cost of getting milk to where it has to be processed.

Lone Star Milk Producers, Inc. opposed proposals Numbers 4 and 5 because the proposals would disadvantage a significant portion of the producer milk supply to the southeast; would create incentives for uneconomic movement of milk; would not provide equity in the treatment of all pool-qualified producers; and would not be in the interest of orderly marketing.

Sincerely,

Jim Baird

Jim Baird
President