United States Department of Agriculture
Before the Secretary of Agriculture

Re:

Milk in the Mideast Marketing Area
76 Fed. Reg. 55608 (Sept. 8, 2011)

Docket No. AO–11–0333;
AMS–DA–11–0067
DA–11–04

Cincinnati, Ohio
October 5, 2011

Testimony of Emil Soehnlen
For Superior Dairy, Inc.

My name is Emil Soehnlen. I am Vice-President and In-House Counsel for Superior Dairy, Inc. Previously, I worked in various departments throughout Superior's organization since 1998, including Vice President of Operations and Chief Financial Officer. In 1993, I received a bachelor's degree in accounting from the University of Notre Dame and in 1996 I received two degrees from the University of Akron, a Juris Doctor and a Masters in Taxation. Later that year, I became a licensed attorney within the state of Ohio as well as a Certified Public Accountant.

I am testifying today on behalf of Superior Dairy and against the proposed amendment to Milk Marketing Order 33. Superior represents 100% of the handlers that would be negatively affected by Federal Order 33 rule changes proposed by DFA, et al. The producers supplying Superior Dairy represent 100% of producers who would have to give up part of their regulated milk revenue under the proposal.

Superior receives about 40 million pounds of producer milk each month, of which about 82% is used to produce Class I fluid milk products. A significant majority of such producer milk is supplied by DFA. In a letter to Superior Dairy from DFA dated May 13, 2011, DFA explained that it is industry practice, and DFA practice, for cooperatives that supply partially regulated distributing plants to charge class prices plus a premium based on plant utilization. Superior Dairy buys milk from DFA consistent with this practice.

I am appearing today to explain why the regulatory remedy proposed by DFA, et al., in response to so-called marketing disorder by a partially-regulated handler's use of part 1000.76(b) in Order 33, should not be adopted. In addition, DFA and other cooperative proponents have ignored or misstated

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material facts in order to exaggerate the claimed competitive or regulatory impact of Superior Dairy's partially regulated status.

At the beginning of my career at Superior Dairy in 1998, the industry was in a state of fluxuation as consolidation at all phases of the industry were occurring. These include processors, retailers, and raw milk suppliers. In addition, the industry was being modified by the federal order reform. As many of Superior's regional competitors began to exit the industry by selling their ownership interests to the large corporations like Dean and Suiza, Superior made a major investment in its newly patented filling and packaging technologies. These new found technologies would give Superior an edge in competition with significantly larger competitors. Setbacks continued to slow the rollout of the new technologies. Such setbacks included two major customer bankruptcies and a large plant fire which destroyed most of the newly engineered technologies. In 2006, Superior again was able to utilize its new technology which quickly caught on with certain customers such as Costco and Sam's Club.

The new technologies expanded Superior's distribution capabilities into many new Federal Orders. As our sales growth occurred in Order 1, and other business was lost in Order 33, Superior was regulated out of Order 33 and into Order 1 in April of 2010. Superior's Order 33 distribution dropped to approximately 20% of its sales, while its Order 1 distribution was at about 28% of its sales. This was bad for Superior and bad for Superior's independent and cooperative producer suppliers. Superior's class price obligations remained the same, of course. Those obligations are accounted for in two payments: one directly to dairy farmers, and another payment to the producer-settlement fund of an Order. When it became regulated in Order 1, Superior paid more into the Order 1 producer-settlement fund, and the blend price payable to producers (at the Canton location) was lower by about 13 cents per hundredweight over a period of 11 months than it would have been had Superior continued to be regulated in Order 33. Superior had to increase the over order premiums paid to its producers to keep them competitive since there were many other handlers buying milk produced in Eastern Ohio that could offer the Order 33 blend price, or even higher blend prices under Order 5. In essence, Superior had to pay more into the settlement fund and more to its independent and cooperative suppliers causing Superior to bear a substantial economic penalty for being regulated into Order 1. Superior was unable to take on additional caseless volume to help regulate them back into Order 33 as the capacity of the caseless line was too constrained. Superior Dairy looked for other options to restore the competitive playing field and keep our producers competitively compensated.

In early 2011, Superior did buy an older facility in Wauseon, Ohio. Superior is very interested in this facility for several reasons.

1. It provided Superior a means in which to drop its Order 1 and Order 33 distribution percentages below 25% and get Superior to qualify for PRDP treatment under 1000.76. As described before, Superior was already close to the 25% threshold in the markets where it had its greatest sales.
2. The opportunity to procure raw milk in this area made the location even more attractive due to the amount of milk located in Western Ohio and Southern Michigan. Wauseon is slated to serve as a redundant operation to "back-up" Superior's operations as well as provide increased manufacturing capabilities for new business.
3. It is close enough in proximity to not have separate administrative functions.
4. Serve as a prototype facility for the caseless milk operation.

By March 2011, the Wauseon plant was running, and Superior distributed enough of its Northeast sales through Wauseon to avoid regulation of the Canton plant in Order 1. Superior did not, at that time, have 25% of its total sales in Order 33, so its Canton plant became partially regulated.

As a result of Canton's shifting from full regulation in Order 1 to partial regulation, it should be emphasized that the Order 33 blend price was not affected at all. Only the Order 1 blend price was affected. The arguments of DFA, et al (hereafter referred to as the proponents), that the Order 33 producers have suffered or will suffer any reduction in blend prices due to Superior's partial regulation are simply, flatly, and unequivocally false. But it is understandable that Order 33 cooperatives would try to gain a blend price windfall, by the DFA, et al proposal, to gain for Order 33 what was lost to Order 1.

Since becoming partially regulated, Superior Dairy has not changed its procurement pricing nor gained new customers by offering lower prices. Assertions to the contrary by the proponents, in requests leading to this hearing, and in testimony by Mr. Hollon in this hearing, are also simply false. Superior has had sales into markets at some distance from Canton for several years. This was the result of innovative technology, not any regulatory advantage. Such sales at a distance appear to be the only concrete expression of concern or complaint to DFA by its other customers, as explained in testimony by Mr. Hollon. These DFA customers, competitors of Superior Dairy, are understandably resistant to marketing innovations of a competitor. DFA apparently hopes to use these complaints as pretext for changes in Order 33 rules so they will be endorsed by its many other customers by targeting Superior Dairy in a unique way.

As advanced by DFA in their request for hearing, DFA suggests that Order minimum values and handler competitive equity are now at issue because partial regulated handlers, specifically under 1000.76(b) can act as an individual handler pool, avoiding payments to the market wide pool. DFA contends these inequities arise because the dollars otherwise payable to the pool can then be used in a competitive fashion in procuring milk supply in competition with pool handlers.

A reminder of the core purpose of "orderly marketing conditions" in the Federal Order System is key to resolution of issues in this hearing The Agricultural Marketing Agreement Act (AMAA) of 1937 states as a declaration of policy:

> "Through the exercise of the powers conferred upon the Secretary of the Agriculture under this title, to establish and maintain such orderly marketing conditions for any agricultural commodity enumerated in section 8c(2) of this title as will provide, in the interest of producers and consumers, an orderly flow of supply thereof to market throughout its normal marketing seasons to avoid unreasonable fluctuations in supplies and prices."

The proponents have repeated the conclusion of "disorderly marketing conditions" throughout its testimony, but have not explained what this means nor how it relates to any threat, real or hypothetical, to the adequate supply of milk, orderly flow of milk, or reasonable prices for milk, which were of concern to Congress in 1937.

The current proposal of the proponents to regulate Superior was advanced by the notion that a distributing plant regulated at the time of federal order reform should not be allowed to break away from full regulation. Mr. Hollon argues on page 5 of his testimony that: "The language in the Federal Order reform decisions which created a uniform pool distributing plant definition and the 25 % level clearly *intended to keep all plants regulated and not to deregulate existing pool plants.*" (italics provided).

This argument makes reference to 64 Fed. Reg. 16312(April 2,1999) which states that:

> "The 15 percent in-area standard in the proposed rule has been changed to 25 percent for all orders to reflect the larger, merged

> marketing areas that are adopted. This change should not affect the regulatory status of any current distributing plant."

However, when reviewing the Federal Register, it appears that the Secretary was primarily concerned with avoiding regulation of plants not previously regulated. Three plants were noted as changing regulatory status from fully regulated to partially regulated as a result of Federal Order Reform, at pp. 16082-86 of the final decision. Thus, the intent of the language quoted by Mr. Hollon can be seen more to prevent the regulation of handlers which were not subject to full regulation rather than keeping all plants fully regulated as the proponents try to imply.

The focus of argument by the proponents, and the source of the problem they identify, is the Wichita Plan Option for partially-regulated plants in Part 1000.76(b), and use of that option by Superior Dairy in particular. As described by proponents in Mr. Hollon's testimony at page 12:

> That option, in general, states that if a plant can demonstrate to the Market Administrator that it has paid producers in aggregate the minimum class values, it will not have any pool obligation. The test takes into account all payments to the producer including any premiums paid. The plant is thus able to operate as if in an individual handler pool, avoiding payments to the marketwide pool. This can amount to a substantial value. These dollars otherwise payable to the pool can be used in a competitive fashion to procure a milk supply in competition with pool handlers.

At page 13, Mr. Hollon estimates that the sums otherwise payable to the pool provides an "advantage," to the PRDP estimated at about $289,000 per month, but admits that this money "must be paid to the plant's milk suppliers." This is because a section 76(b) handler, or an individual handler pool plant, must always pay at least minimum class prices for all milk received, just like pool plants in a marketwide pool.

On page 14, however, Mr. Hollon takes the argument a step further and asserts "that the "advantage" funds can also be used by the plant to gain market share for packaged fluid milk products." This conclusion is plain wrong if we are dealing with regulated minimum prices -- and Mr. Hollon repeatedly said that he was talking about regulated minimum prices, and regulatory advantages. Mr. Hollon, in fact, declined on cross-examination to discuss over-order premiums paid for raw milk, except to acknowledge that payment of premiums could occur.

The Wichita option, in fact, provides no competitive *sales advantage* for partially-regulated handlers at minimum regulated prices, as explained in numerous USDA decisions.

The Wichita option was originally adopted for the Wichita milk order in 1951, at the request of a cooperative with a plant near Wichita that primarily sold milk to other markets. The Secretary agreed with the option proposed, and rejected a proposed compensatory payment equal to the difference between the Class III price and fluid use prices, explaining:

> ...the [partially-regulated] handler through choice or because of competitive conditions may pay farmers more than the Class III price for such milk, and as a result have a higher cost than the class prices on the milk so disposed of in the marketing area.... If through choice or competitive conditions these payments are equal to the amount that the order now provides at class prices on his entire utilization, the requirement of additional payments is not necessary to provide uniformity of costs to handlers and protection to regular producers. **** [The Wichita Plan adopted] will ensure uniformity of costs of milk among handlers, and will recognize the payments that non-pool handlers choose to make to approved dairy farmers.

16 Fed. Reg. 1242, 1243 (Feb. 9, 1951)(Recommended Decision), 16 Fed. Reg. 2519 (Mar. 17, 1951)(Final Decision). A half-century later, the Secretary came to the same conclusion in the course of federal milk order reform. He concluded that the Wichita option for partially-regulated plants would "equalize the competitive positions of both fully regulated plants and those plants not regulated under an order...." 64 Fed. Reg. 16026, 16163 (April 2, 1999).

For producers, however, we agree with the proponents, that use of the Wichita option may produce non-uniform farm milk prices because the option allows the partially-regulated plant to operate "as if in an individual handler pool." These same observations, and the same criticisms, were made in the Nourse Report in 1962.

> Compensatory payments or some equivalent device are especially needed with respect to milk that moves from a market with individual handler pooling to a Federal order market with market-wide pooling, to protect the integrity of the pool.
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> * * * *

> In the case of milk sold on routes within the marketing area by an unregulated handler, many of the orders provide that the compensatory payment may be calculated ... [by handler option] as follows:
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> > The difference between the total amount paid by the unregulated handler to his producers and the amount he would have been required to pay for his milk if fully regulated by the order.
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> This latter method of computation, commonly known as the "Wichita Plan", is objectionable because in effect it sets up an individual handler pool for the unregulated handler, while the fully regulated handlers with whom he is competing are required to equalize. If the unregulated handler has a higher Class I utilization than the average for the market his producers will fail to bear a proper share of the burden of maintaining the reserve supply.

Report to the Secretary of Agriculture by the Federal Milk Order Study Committee (April 1962) pp. II-4-26 to -27. There was apparently a regulatory policy in place at the time of the Nourse Report limiting or prohibiting use of the Wichita option where the procurement area of partially-regulated and fully-regulated handlers overlapped.

> "The Committee is informed that the "Wichita Plan is not authorized in situations where the unregulated handlers are found to be buying milk in competition with the handlers fully regulated by the order."

Nourse Report, p. 11-4-27, fn. 7. This policy is no longer in place, and its absence is the source of potential farm milk price disparity described by the proponents.

But even though PRDP or individual handler pools may produce a higher blend price, it cannot be said that marketing disorder necessarily results. It is the consequence of blend price differences, not there mere existence, that demonstrate disorder, if any. That is true in this case. The PRDP blend price received by Superior's producers is admittedly higher than Order 33 blend prices. But Superior's plant is operating close to its processing capacities, with limited ability to increase its milk supply. Order 33 and its pool plants will continue to receive an adequate supply of milk under prices that have prevailed in Order 33 for more than 18 months without Superior as a pool plant.

Additionally, the availability of the Wichita option provides no competitive advantage in procurement or sales, and no lost blend price opportunity for pool producers, whenever a partially-regulated handler buys milk from a cooperative association at class prices plus premiums. It is the cooperative's option, when this takes place, to pool the milk on its handler report. If a cooperative elects not to pool, it receives the kind of benefit Mr. Hollon has calculated hypothetically in Exhibit 25, but the hypothetical "advantage" is retained by the coop rather than the plant.

An additional wrinkle in the competitive and regulatory analysis is the ability of some handlers to coordinate distribution from two or more company plants in order to maximize Wichita option pricing opportunities for one or more plants that remain unregulated. The proponents identified the two plants operated by Superior Dairy in Ohio, one regulated (in the Northeast) and the other partially regulated, at which such opportunities apply. The economic reality apparently relied upon by Mr. Hollon is that where incentive and opportunity exist to improve a company's bottom line, a rational decision is to take advantage of that opportunity.

There are several other handlers operating multiple plants that have similar incentives and opportunities. Several of these compete for raw milk and/or fluid milk sales with Order 33 handlers, and are therefore "similarly situated" to Superior Dairy by competitive factors. These include: (1) the Tuscan – Lehigh (Dean Foods) plants in Lansdale, Pa. (fully regulated Order 1) and Schuylkill Haven, Pa. (partially regulated); (2) Schneider Dairy plants in Pittsburgh, Pa. (fully regulated Order 33) and Williamsport, Pa. (partially regulated in most months); (3) Marva Maid plants in Landover, Md. (fully regulated Order 1) and Newport News, Va. (partially regulated). I understand that the agenda and proposals at this hearing are limited, and do not mention these plants to propose another option beyond the scope of that limitation. However, the Secretary at the end of the day must make a determination that the regulatory remedy selected, if a decision is made to amend the Order, is "the only practical alternative available" to benefit producers. 7 U.S.C. §608c(9). Thus, if the Secretary becomes aware of practical alternatives that lie beyond the limited scope of a hearing agenda, the final decision should be to deny the unduly-limited proposal. That should be the Secretary's decision in this case, regardless of whether the limitations in remedies available by the Hearing Notice were self-imposed or inadvertent.

It does not appear that shift in plant status from full regulation to partial regulation, and everything that follows such a shift as described by Mr.

Hollon, is disruptive or disorderly enough by itself to merit FMMO amendment. The Northeast Market Administrator's Bulletin for July 2011, at p. 2, observed that changes in plant regulation changed the volume of milk in Class I under that Order: "For example, a large distributing plant regulated under the Order in 2006 became partially regulated for 2010 and part of 2011." Exhibit ________. This, as I understand it, was a plant that had sister plants through which sales could be coordinated to help the plant flip into or out of partial regulation. No hue and cry, or call for FMMO amendment, followed these events.

DFA also contends that similarly situated plants in the same competitive marketing area having differing costs of raw milk is a disorderly marketing condition.

Superior offers a simple, rational response to this assertion. PRDPs have been operating in this area and against similary situated pool plants for a long time; however, these activities were not categorized as disorderly until now, and now only for one PRDP plant. Schnieder Dairy, with a fully regulated Order 33 plant and a PRDP in Pennsylvania, has a milk procurement area as well as sales territory that overlap with Order 33 and Order 1 handlers, as disclosed in the Schnieder website that I downloaded and printed. This is shown on Exhibit 26. These plants, on procurement and distribution factors, are similarly situated to Order 33 and Order 1 plants. The 1998 letter DFA offered to Secretary Glickman in which DFA contend that PRDP's in the unregulated PA markets are similarly situated to Order 33 and Order 1 handlers because a) they compete in the same market and for the same supply as other regulated plants, and b) they benefit from the FMMO system without having to burden in the costs, makes the same point.

Proponents argue that justification for their proposal is found in lock-in provisions for ESL and UHT milk plants. The Federal Order lock-in provisions for extended shelf life milk was created, as I understand it, because these plants had the ability to establish route disposition in varying markets, and could easily shift regulation from one market to another. Thus, blend prices to producers could vary to the detriment of the handler and the producers, particularly if the plant became pooled on a distant market where blend prices were lower than the market in which the plant procured its milk supplies. DFA fails to mention the other defining characteristics that make ESL milk distribution potentially disorderly – which include erratic processing because of the ability to build inventory (which prevents smooth supplies of milk).

Having said that, the difficulties experienced by ESL plants and their producers when faced with shifts in regulation from one market to another, and the burden of being pooled on a market with a blend price lower than the market in which the plant is located, rings a familiar bell when we look at what happened to Superior Dairy in April 2010. It shifted from regulation under Order 33 to Order 1, and its producers received lower regulated blend prices as a result. Superior had hoped to avoid this result by purchase and operation of the Wauseon plant at substantial cost. Now, the economic viability of the Wauseon plant is brought into question by the proponents' proposal. Superior would be burdened with a substantial cost that may not outweigh the disbenefit of returning to regulation in Order 1, which would unavoidably happen if the Wauseon plant were to close.

While we feel that no amendment should be recommended by the Secretary as a result of this hearing, if the Secretary should nevertheless feel compelled to do something, that something should be to lock Superior Dairy into Order 33 the same way that ESL plants are locked into the Order in which they are located. Superior should not again be subject to flipping into and out of Order 1 simply because its sales into Order 1 are above 25% of total route disposition. The DFA, et al, proposal does not, for unexplained reasons, deal with this problem. But proponent's testimony quite adequately demonstrates that such shifts are harmful to plants and the producers that supply them.

For this reason, we suggest, for illustration, the following alternative modifications of Proposal No. 1, consistent with limitations in the Notice of Hearing, should any amendment be recommended by the Secretary and submitted to producers for their approval:

> "**** Plants located within the marketing area with combined route disposition and transfers of at least 50% into Federal Order marketing areas ~~but without 25% of route disposition and transfers into any one Federal Order~~ will be regulated as a distributing plant in this Order."
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> OR
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> "**** Plants located within the marketing area with combined route disposition and transfers of at least 50% into Federal Order marketing areas, ~~but without 25% of route disposition and transfers into any one Federal Order~~ and such distribution is into four or more marketing areas, will be regulated as a distributing plant in this Order."

An amendment of this type would lock in Superior Dairy to Order 33, benefit pool producers in the common milkshed, avoid losses of Superior Dairy's contribution to the pool if its distribution to other markets goes up and down, generally avoid the kind of difficulty experienced by

Superior Dairy and its suppliers from April 2010 through February 2011, and affect no other plant in the market, to our knowledge.

That concludes my testimony.