

**BEFORE THE UNITED STATES DEPARTMENT
OF AGRICULTURE
AGRICULTURAL MARKETING SERVICE**

In the Matter of :
Milk In the Southeast and Appalachian : **Docket Nos.:**
Marketing Areas : **AO-388-A15,**
: **AO366-A44,**
: **DA-03-11**
:

BRIEF FOR SOUTHERN MARKETING AGENCY, INC. (SMA)

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I. INTRODUCTION AND OVERVIEW

A. Proponent Southern Marketing Agency and Other Parties To this Proceeding

Proponent, Southern Marketing Agency, Inc. (“SMA”) is a common marketing agency for cooperative member producers who supply pool distributing plants regulated under the Appalachian Federal Order 1005 and the Southeast Federal Order 1007. Southern Marketing Agency, Inc. performs a common pooling of certain costs and returns for member producers supplying Appalachian Federal Order 1005 and Southeast Federal Order 1007 pool plants.

The producer constituents of SMA are members of the following cooperative organizations: Arkansas Dairy Cooperative Association, Inc.; Dairy Farmers of America, Inc.; Dairymen’s Marketing Cooperative, Inc.; Lone Star Milk Producers, Inc.; Maryland & Virginia Milk Producers Cooperative Association, Inc.; Southeast Milk, Inc. (Exhibit 48 Item 1) Arkansas Dairy Cooperative Association, Inc. and Lone Star Milk Producers, Inc. are cooperatives based in Arkansas and Texas respectively. They each have about 160 producer members. Both Lone Star Milk Producers and Arkansas Dairy Cooperative Association currently market milk under Order 7 and Lone Star currently also supplies Order 5 plants. Arkansas Dairy Cooperative has supplied Order 5 plants in the past. (Wiedower, Tr. 125–135) Dairymen’s Marketing Cooperative, Inc., is based in Mountain Grove, Missouri, with 168 producer members. It currently delivers milk to plants regulated under Order 7 and has delivered to Order 5 in the past. (Bray, Tr. 138, 142) Maryland and Virginia Milk Producers Cooperative Association is composed of 1450 to 1500 producer members and delivers milk to both orders 5 and 7. (Asbury, Tr. 111-112, 117) DFA is a national dairy cooperative with more than 13,000 members.

It markets milk to plants regulated under both Orders 5 and 7 and represents nearly 50% of the milk, and more than 50% of the producers, in the two orders. (Hollon, Tr. 230) Southeast Milk Inc. is a dairy cooperative based in Florida which markets its members' milk under Order 7, as well as Order 6. The membership of these six proponent cooperatives, for November 2003, accounts for approximately 734 million pounds of producer milk, which likely will be pooled, on the proposed Southeast Federal Order. This represents approximately 66.62 percent of the total producer milk that will be pooled on the proposed Southeast Order. (Exhibit 48, Item 2)

These proponent cooperatives also market the milk of other cooperatives whose member milk will be pooled on the proposed Southeast order. Thus, in total for the month of November 2003, the proponent cooperatives marketed approximately 871 million pounds of producer milk that will likely be pooled on the proposed Southeast Federal Order. This would represent approximately 79.07 percent of the total producer milk that will be pooled on the proposed Southeast Federal Order. (Exhibit 48, Item 2) In addition, the proponents market, through DMS, an additional substantial share of the 15–20% of the milk in the order of producers who are not members of any cooperative. (Hollon, Tr. 387–389) Thus, in aggregate the SMA operations account directly for about 80% of the milk and through DMS for a substantial share of the nonmember milk marketed under both existing orders and which would be anticipated to be pooled on the merged order.

One or more of the proponent cooperatives supply each of the fifty-two (52) plants that will be fully regulated pool distributing plants under the proposed Southeast Order. There are also thirty (30) plants to which five (5) other cooperatives' member producer milk was marketed by the proponent cooperatives. (Exhibit 48, Item 3)

The proponent SMA, its members and affiliates, is the predominant marketer of milk in the proposed combined order area. As such, its knowledge of the marketing area, marketing conditions, problems, and what is needed to improve marketing conditions should be given due consideration by the Secretary. In this context it is significant that SMA is not a federation which is formed only for purposes of advocacy, or which is readily capable of reconstitution or dissolution. Its members have entered into long term marketing agreements which reflect their joint and collective long term commitment to supplying the fluid milk needs of the Southeastern United States. (Hollon, Tr. 340-41) The request for this hearing is an important effort which the SMA cooperatives have undertaken to improve marketing of fluid milk in this important region of the country and the federal order system.

Dean Foods Company is a national dairy company with bottling plants and other dairy product facilities in both Orders 5 and 7. Dean is one of the proponents of Proposals 5, 6, and 7. The other proponent of proposals 5, 6, and 7 is Prairie Farms Dairy, a regional dairy farmer cooperative and distributing plant operator based in Illinois. Prairie Farms does not own plants in Orders 5 or 7 but is an operator of plants in these markets.

The Kroger Company, proponent of proposal 4, is a national supermarket chain and food distribution firm, which operates distributing plants in both Orders 5 and 7.

Sarah Farms is an Arizona producer-handler with no sales or operations in either Order 5 or Order 7.

Select Milk Producers, Inc., and Continental Dairy Products, Inc., are cooperatives of large dairy farms located in the Southwest (Select) and in the Indiana/Ohio/Michigan area

(Continental).¹ DFA is a marketing agent for Continental. Producers of both Select and Continental presently have milk pooled or have had milk pooled on Orders 5 and 7. (Tr. 327–328)

B. Summary of Southern Marketing Agency Position

This four-day hearing was consumed with two primary topics: (1) whether the marketing areas of Orders 5 and 7 should be merged, or otherwise reconfigured; and (2) whether the exemption for producer-handlers should be reformed to place a 3 million pound maximum monthly distribution on such exempt handlers. Both of these issues are important to the Southern Marketing Agency and its members. We urge the Department to move forward on these issues as promptly as possible. If it is possible to move forward on one issue prior to the other, we would respectfully request that the Department issue a partial recommended decision for one issue or the other, prior to the other. We believe that this approach to resolving the issues would be in the best interests of all concerned in the industry in the southeastern United States.

Marketing of milk in the southeastern United States is unique in several respects. It is a milk deficit area in which production continues to decline while demand continues to increase. This condition is uniform to both Order 5 and Order 7. The Southeast is also a region where

¹ The participation of Select and Continental in this proceeding is curious, if not bizarre. Their counsel participated in an adversarial fashion (e.g., Motion to strike Herbein testimony. Tr. 546) with respect to Proposal 7 which would regulate large producer-handlers. Select and Continental have now endorsed that same proposal in Order 131 (see post-hearing brief submitted in that proceeding, see http://www.ams.usda.gov/dairy/pnw_alv/brief1.pdf). They are not producer-handlers, but their counsel is counsel of record for the producer-handlers in Order 124 who may be the real parties in interest here. Alternatively, perhaps Select and Continental oppose large producer-handlers in Order 131 (where their processing operations as described in their post-hearing brief involve Class III uses “concentrat[ing] milk for marketing to cheese plants throughout the country;”) but support large producer-handlers in other orders, such as these, where they could enter the Class I market from large farms in Indiana/Ohio/Michigan.

marketing is coordinated by a single cooperative agency of dairy farmer cooperatives. The regional agency, which coordinates and oversees marketing of the great majority of milk in both Orders 5 and 7, administers the area as a single market but is hampered in doing so by the current bifurcation of the region into two separate marketing order areas. The region should be united under one single milk market order as requested in Proposals 1 and 2. In addition, the marketing area should be expanded with the addition of several counties in Southern Virginia to stabilize marketing for plants in that region. In the merged order, the qualification for producer milk should be revised to apply on a percentage basis as opposed to day of the month basis and dual pooling on federal and state orders with marketwide pools should be prohibited. The proposal of Dean Foods Company to split the region into multiple, differently-configured orders should be rejected.

It is important that the producer-handler provisions in this region be revised to cap or limit the exemption for sales of Class I by the producer-handler to 3 million pounds per month. There are not presently any producer-handlers who would be immediately affected by this proposal. However, developments in other areas of the country and the existence of production technology on large farms shows that the exemption from pooling for producer-handlers could attract the entry of large producer-handlers into this market. This would be a highly disorderly development which should be foreclosed. The participation in this hearing in opposition to this limitation by a large producer-handler from the southwestern United States and two regional cooperatives of large producers underscores the potential for such entities to participate in the southeastern market.

II. ORDERS 5 AND 7 SHOULD BE MERGED; THE MARKETING AREA SHOULD BE EXPANDED IN VIRGINIA; AND PROPOSAL 5 TO SPLIT THE EXISTING SOUTHEAST ORDER SHOULD BE REJECTED

A. The Case for Merger.

1. Current disruptive and disorderly conditions.

There are several current disorderly, disruptive marketing conditions which will be resolved by adoption of the proposal for merger of the Orders.

Blend Price Differences: The differences in the Class I, Class II, Class III, and Class IV utilization of producer milk pooled under the Southeast Federal Order No 1007 and the Appalachian Federal Order No. 1005. leads to significant blend price differences which contributes to disruptive marketing conditions in the major areas of common producer milk supply.

The differences in blend prices between the Appalachian Order 1005 and the Southeast Order 1007 by months for the period January 2000 to date appear on Exhibit 48, Item 34. This Exhibit also shows a combined Order 5 and Order 7 weighted average Blend Price for the period, and the variation of that combined blend price from the actual Appalachian Order 1005 and Southeast Order 1007 blend prices. The significant price differences shown contribute to the disruptive marketing conditions currently present in the proposed Southeast marketing area.

The difference in the Class I utilization of producer milk pooled on the two Orders is due primarily to a disproportionate burdening of the balancing of the supply of milk necessary to meet the two Orders' needs by the Southeast Federal Order No. 1007 pool. Producer milk pooled on the Southeast Federal Order No. 1007 is shifted to the Appalachian Federal Order No. 1005 to meet its needs during the fall.

The difference in the Class II utilization of producer milk pooled on the two Orders is due primarily to the existence of at least three Appalachian Order pool distributing plants which have significant Class II operations and which supply a portion of the Class II needs of their operations, or stores, in the Southeast Order marketing area.

The difference in the Class III and IV utilizations of producer milk pooled on the two Orders is primarily a result of the usage of surplus milk at Class III cheese operations in the northwestern Arkansas and Southern Missouri supply area of the Southeast Order. In the common producer milk supply areas of the two Orders, the disposition of surplus producer milk to Class III and IV usage is similar. However, due to the difference in prices for the two use Classes, significant blend price differences do occur.

Since the differences in blend prices between the current Orders 1005 and 1007 are generated largely from differences in uses and prices in the manufacturing classes, and not primarily from differences in Class I milk utilization, pooling additional milk on the higher blend price Order to lower its blend price is ill-advised. Under the current market structure, the blend price advantage enjoyed by Order 1005 producers over Order 1007 producers would be erased with modest increases in the Class III price. Such was the case in August and September 2003 when Order 7 had a higher uniform price than Order 5, despite a Class I utilization percentage that was greater in Order 5 than in Order 7. As such, the blend price inequities and disruptions that now exist would simply be flip-flopped and would continue. If additional milk had been pooled on Order 1005 to blend down the uniform price so that it equaled the Order 1007 blend price, and such a change in the Class III/Class IV price relationship were to occur, the blend price inequity issue would be magnified, with Order 1007 having a higher Class I utilization, and additional pool revenues from the higher Class III price.

This concern is always present – that is, without a merger, under present marketing conditions, there will always be a group of producers who feel disadvantaged by the blend price relationship. When class price relationships change, the emotion simply shifts to the other Order – even though there is little change in the supply demand patterns in the every day functioning of the market.

The existence of the separate Orders, which divide a single fluid milk market, oftentimes encourages suppliers who have the potential ability to perpetually attempt to equalize the Order blend prices by shifting supplies back and forth between Orders. Inherent in this attempt to equalize the Orders' blend prices by shifting pooled milk is the hopeful predicting of the relationships of the Class II, Class III, and Class IV prices; market uses of Class I; and the determination of which supplies to shift onto or off of one of the Orders; and the costs associated with doing so. Such a system is disorderly on its face. Others have suggested that the disruptive blend price differences have resulted from an Order 5 uniform price that has most often exceeded the Order 7 uniform price. The disruptive blend price differences would be just as acute if the Order 7 uniform price was regularly greater than the Order 5 uniform price. The inherent problem is that the uniform prices are not equal across this single fluid milk market.

To help minimize the disruptive marketing condition resulting from the blend price differences which have occurred, beginning April 2002 the member cooperatives of the Southern Marketing Agency, Inc. began the common pooling of the costs and returns to supply member customers regulated under the Appalachian Federal Order No. 1005 and the Southeast Federal Order No. 1007. While this procedure has helped resolve the disruptive pricing difference between the members of the cooperatives involved, it will not equally share the burden for all the producer milk pooled on the two Federal Orders. Only a merger of the Southeast Federal Order No. 1007 and the

Appalachian Federal Order No. 1005 will resolve the inequities that exist.

Transportation Pool Differences: The current system of two Transportation Credit Balancing funds, with differing levels of payout has resulted in disorderly marketing conditions, manifested in two ways. As shown in Exhibit 29, the Transportation Credit Balancing funds have not been adequately funded nor are funds drawn paid to suppliers in an equal manner. The Transportation Credit Balancing fund in Order 7 has been exhausted in each year 2001, 2002 and 2003, while the Order 5 Transportation Credit Balancing fund has been sufficiently funded to pay virtually all claims requested since 2000. The market administrator for Order 7 has had to prorate payments from the fund while the market administrator for Order 5 has not, except in December 2003.

The first instance of disorderly marketing resulting from this problem is unequal costs of milk. The inequity in payout between the two Transportation Credit Balancing funds has resulted in unequal supplemental milk costs to handlers regulated by the two Orders. Handlers procuring supplemental milk for Order 5 have been reimbursed at virtually 100% of their claimed credits, while handlers procuring supplemental milk for Order 7 have been reimbursed at approximately 50% of their claimed credits. This inequity results in an unequal regulated cost of milk, and equal costs of milk for handlers similarly situated is a hallmark of the Federal Order regulation. The two current Orders share a common milk shed, with producers, especially producers outside the marketing areas, regularly serving both current Orders. Exhibit 48, Item 18, Delivery Location of Other Producer Milk Located in Other Marketing Areas Calendar Year 2003 (map) and Exhibit 48 Item 19, Southern Marketing Agency, Inc. Primary Sources of Supplemental Milk Supplies (table) depicts the four major sources of outside the marketing areas supplemental supply for the current Orders 5 and 7, and the area those supplemental supplies service. As can be seen, each of the four major

sources of outside the marketing areas supplemental supplies services plants located in and regulated under both Orders 5 and 7. This milk suffers the loss when the two current Orders' Transportation Credit Balancing fund payments are not sufficient, or suffers inequities in returns when the payouts of the two Orders' funds are not equal. Much of the milk that is currently procured outside the marketing areas can serve both current Orders, and as such, this milk should be treated equitably with regard to the Transportation Credit Balancing fund payments such milk is entitled to under the Order program.

The second manifestation of disorderly marketing caused by the transportation pool inequities is encouraging uneconomic movements of milk, and in limiting economic movements of milk. The inequity in payout between the two Transportation Credit Balancing funds has resulted in milk moving further distances than would be required if a single Transportation Credit Balancing fund were instituted. Exhibit 48, Item 40, Comparison of Transportation Credit Fund Payments FO 1005 vs. FO 1007 When Order 7 Prorates and Order 5 Does Not describes how milk moves to the current Order 5 in deference to Order 7 purely for the purpose of garnering the higher transportation credit payout available in Order 5. Since the same milk from outside the marketing area can serve both Atlanta and Greenville, the economic and rational way to route the milk would be to serve nearest plant, domino-ing local and distant milk to fill the demand. Rather, as a result of the inequity in payout between the two Transportation Credit Balancing funds, milk will move farther than necessary. On the other side of the inequity, milk from the Middle Atlantic region can economically move well into the current Order 7 area to service plants there. However, during the time when Order 7 is prorating transportation credits the milk does not move beyond the borders of Order 5,

since the return to this milk would be reduced precipitously when earning only a partial transportation credit on Order 7.

Producer qualification disorder. Furthermore, the current divergeant producer qualification provisions of the orders presents marketers with daily dilemmas. The marketing difficulty presented by the current multiple orders was cogently summarized by Ms. Bray for Dairymen's Marketing Cooperative: "We have just [currently] been on Federal Order 7, but in the past, we had milk pooled on 5 and it is the same – you have to really watch to be able to pool your milk. If you are not careful, you will not be able to pool on either Federal Order." (Tr. 142–143) The producer qualification provisions of the orders are different, and additive. As Mr. Asbury of Maryland and Virginia testified (Tr. 116): "You have to meet pooling days for each order and it could cause problems . . . You go five days with one [order] and nine to another [order] and not be pooled on either one, so that is what we are talking about" in terms of marketing problems under current provisions.

This was detailed further by Mr. Hollon (Tr. 250–252):

While there is producer milk which moves between and amongst the two Orders, the producer qualification criteria of the two Orders as they currently exist [exist] forms a regulatory barrier to the free and efficient movement of this milk. In effect, the "producer touch-base" requirement for market association and diversion qualification is additive as the two Orders exist today. That is, in order to insure producer qualification on a producer which may be efficiently and effectively pooled on either of the two current Orders, the producer touch-base requirement in the short-supply months is, in actuality, 16 days per month. That is the six days required in the Appalachian Order plus the 10 days required in the current Southeast Order. Also there is a cumulative nature to the computation because if you lose association with one market you must start over again.

Additionally, the requirement that a producer re-associate with a Federal Order market by being physically delivered to a pool plant

limits flexibility and efficiency in milk movements. A producer whose milk can be easily shifted between distributing plants in the current Order 1005 area and the current Order 1007 area is treated in this re-association matter as if the producer was off one of the markets for some reason other than the supply of milk to a nearby Class I plant. For example, a producer located in central Tennessee can equally reach either the distributing plants located in either the Nashville area or the Knoxville-Athens-Chattanooga corridor. As the Orders exist today, these producers must be assigned to one of the two Orders on a monthly or seasonal basis, and if the producer is shifted between the Orders, must re-associate with the producer's "home" Order by delivery to a pool plant prior to diversion, even though the producer was supplying a distributing plant only a short distance away and which likely is supplying Class I packaged fluid milk in the area in which the producer is located. This amounts to a regulatory limit on the efficient delivery of producer milk to a common Class I market.

Together, these conditions are symptomatic of a single market for fluid milk which is subject to multiple regulatory pools. Proposals 1 and 2 address these conditions.

2. These conditions are symptoms of a market which has changed since its promulgation was formulated.

Significant changes in market structure have occurred since the implementation of the final rule on January 1, 2000 which supports the conclusion that maintaining separate Appalachian Federal Order 1005 and Southeast Federal Order 1007 is no longer appropriate. These changes are reflective of the conditions which supported the consolidation of Federal Milk Marketing Orders effective January 1, 2000. As fluid milk processors increasingly serve larger geographic areas fewer orders are appropriate. With respect to the proposed Southeast Marketing area this is certainly the case. Processors have significantly increased their sales areas over the past years, thus increasing the need for, and this proposal for the merger of the Appalachian Federal Order 1005 and the Southeast Federal Order 1007.

The current market has functioned since January 1, 2000. But its provisions and supporting rationale are rooted in a 1996 database². Today, eight years later, our evidence shows that marketing conditions have changed significantly and warrant modernization of the Order to reflect the dynamics of the new market.

In January 1996 there were 72 physical plant facilities which were, or would become fully regulated distributing plants on the Appalachian and Southeast Orders. In December 2003 there were just 52 physical plant facilities remaining that were fully regulated distributing plants on the Orders, a decline of 27.8 percent. (Exhibit 48 Item 4, Pool Distributing Plants Appalachian Order No. 1005, and Exhibit 48 Item 5, Pool Distributing Plants Southeast Order. No. 1007)

Of the plants existing in both periods, more than two-thirds have experienced at least one ownership change during that time, and some of those plants have experienced several ownership changes. In reviewing the plant operation and ownership histories it is interesting to note that of all the fully regulated distributing plants pooled on the Appalachian Federal Order 1005 and the Southeast Federal Order 1007 in December 2003, only seven plants not owned by a grocery store company have experienced no ownership change in the last eight years.

Exhibit 48 Item 7 lists the regulation and operational changes in supply plants pooled on the Appalachian Federal Order 1005 and the Southeast Federal Order 1007 for the January 1996 to December 2003 period. As shown in the exhibit, there were one-fourth fewer supply plants pooled on the Appalachian Federal Order 1005 and the Southeast Federal Order 1007 in

² Proponent cooperatives submitted a number of documents that provide an overview of some of the structural and market changes that have occurred in this area over the last several years. To compare with the data underlying federal order reform, the comparisons are largely between January 1996 and December 2003. Some data are annual comparisons are between 1996 and 2003.

December 2003. Two of these plants, Louisville, Kentucky and Greenville, Tennessee, are operated only seasonally. Since December of 2003 the Greenville plant has been sold to a private concern.

Considerable changes that have occurred between 1996 and 2003 in cooperative associations in the region. (Exhibit 48 Item 8)³ Sixteen cooperative associations delivered milk to plants pooled on what would have been predecessor Federal Orders to the Appalachian Federal Order 1005 and the Southeast Federal Order 1007 during 1996, and fourteen cooperative associations delivered milk to these Orders during 2003. However, only six cooperatives delivered milk in both 1996 and 2003. Eight of the cooperative handlers pooling milk in 1996 no longer exist, and four cooperatives have been newly formed, either as "start-ups" or were formed via the merger of one or more predecessor cooperatives. The other "new" cooperatives delivering milk in 2003 versus 1996 demonstrate the extent to which the milk shed for the southeast has expanded.

Producer numbers in the region continue their long term trend of decline. (Exhibit 48 Item 9) Grade A milk producers in the eleven southeastern states outside of Florida declined from 11,712 to 7,180 between 1996 and 2003, a reduction in excess of one third. The drop in the number of producers in the region is also highlighted by the drop in the number of producers pooled on the current Appalachian and Southeast Orders. According to the March 12, 1999 decision of the Secretary, over 8,180 producers were expected to be pooled on the consolidated Appalachian and Southeast Federal Orders in December 1996 and January 1997. Today, even

³ This exhibit lists the cooperative associations who have pooled milk on the Appalachian Federal Order 1005 and the Southeast Federal Order 1007.

after the addition of a number of producers, many of which are farms located physically outside of the marketing area, only 7,243 producers served the two Orders during December 2003.

(Exhibit 48 Item 16)

Milk production in the region has also continued its long-term trend of decline. (Exhibit 48 Item 10) Milk production in the eleven southeastern states outside of Florida declined from 13,518 million pounds in 1996 to 10,671 million pounds in 2003, a decline of 21.06 percent. This significant decline in the number of Grade A milk producers, and the declining volume of milk production in the region coupled with an increase in population within the marketing area has led to the major expansion in the milk shed for the southeast. There were 9,071,901,486 pounds of Class I producer milk pooled on the combined Orders 5 & 7 during 2003. With milk production totaling 10,671 million pounds in 2003 for the eleven states referenced, this means that 85 percent of the Grade A milk production on an annual basis is needed in Class I. This acute milk deficit, with milk production insufficient to even provide a sufficient reserve above the Class I needs, is a condition unique to the southeast. ***In our view, any regulatory structure that causes one load of milk to go underutilized in the region must be evaluated critically and changed to allow the most efficient use of the limited local supplies.***

In summary, the Southeast has experienced substantial and substantive changes in the market and its structure. The number of distributing plants has declined dramatically. A substantial reduction in the number of pool supply plants is also evident. Producer numbers within the area have declined even more rapidly, and the milk shed has increased in geographic size accordingly. Cooperatives have experienced substantial consolidation, and have together formed Southern

Marketing Agency, Inc., as an extension of the cooperatives' moves to consolidate and seek out enhanced marketing and logistics efficiencies.

Any analysis using the traditional structure, conduct and performance models would point to a southeastern market very much unlike that which existed just seven or eight years ago. As the southeast market structure has changed by consolidation of operations at the producer, handler and cooperative levels, so should the Federal Order Program consolidate the two southeast region Orders to reflect these new structural realities.

In December 2001 two new national fluid milk distributing companies were formed which represent a substantial increase in the market concentration of fluid milk processing in the southeastern United States. The market concentration of these two companies represents in the area of 40 percent of the milk purchases by pool distributing plant in the proposed Southeast Order. Market concentration of this magnitude is unprecedented in the fluid milk business. The consolidation of control and decision making on the operation of such a large proportion of the Class I processing and distribution across the region only expands and magnifies the need to dissolve the current boundary between the two Orders.

Exhibit 48, Item 11 shows the location of the top seven (in terms of dollar sales) Appalachian Federal Order 1005 or Southeast Federal Order 1007 pool distributing plants owned by the top seven fluid milk companies which are supplied by Southern Marketing Agency, Inc. member cooperatives. This map graphically displays the market concentration resulting with the formation of two national fluid milk-distributing companies in December 2001.

In April 2002, five cooperative associations formed a new marketing agency in common whose principal purpose is to cooperate fully in supplying, and increasing the efficiencies in

supplying the fluid milk needs of the southeastern United States outside of Florida. Since that time, a sixth cooperative has joined the Southern Marketing Agency, Inc.

Southern Marketing Agency, Inc., as has been pointed out, pools and redistributes the costs and returns from serving the single fluid milk market currently defined by much of the Appalachian Federal Order 1005 and the current Southeast Federal Order 1007. Southern Marketing Agency, Inc., considers the entirety of this area to be one market in terms of distribution or revenues, allocation and pooling of marketing costs, and measurement of milk supply and demand. The annual milk budgets developed by Southern Marketing Agency, Inc. considers the combined Appalachian Federal Order 1005 and the Southeast Federal Order 1007, for purposes of assessing needs for supplemental supplies, disposal of seasonal surplus supplies, and the direction and assignment of agency-producer-member supplies.

Since the implementation of the final rule January 2000, structural changes have also occurred outside the marketing areas of the Appalachian Federal Order 1005 and the Southeast Federal Order 1007 which impact the supply and demand for milk in the area, and the manner in which the single market is serviced. The establishment of large farms in areas outside the southeast, and which are or can be associated with the southeast, cannot be overlooked. Milk from these large farms can be delivered to locations in either of the current two Orders every week of every month, and represent a regular out-of-area supplemental supply for both Orders.

The continued existence of the two Federal Milk Marketing Orders across a single fluid milk market inhibits market efficiency in supplying and balancing the market. creates unjustified blend price differences, encourages uneconomic movements of milk, and results in the inequitable sharing of the Class I proceeds of the single market.

3. Application of the criteria which the Secretary has applied for market definition mandates the proposed merger.

The most-clearly and currently articulated criteria for consolidation of Federal Milk Marketing Orders are those which were used in the final rule for federal order reform. Therefore, we will review here the record pursuant to those criteria to determine whether a sufficient degree of association in terms of sales, procurement, and structural relationships exists to warrant the consolidation of the Appalachian Federal Order No. 1005 and the Southeast Federal Order No. 1007.

Overlapping route disposition: The movement of Class I packaged milk between Federal Milk Marketing Orders indicates that plants from more than one Federal Order are in competition with each other for Class I sales within the areas. In addition, a degree of overlap that results in the regulatory status of plants shifting between orders creates disorderly conditions in changing price relationships between competing handlers and neighboring producers.

Distances of major population centers of the Appalachian Federal Order and the Southeast Federal Order are generally within the reasonable distribution areas of pool distributing plants regulated under the other Order. The Appalachian Federal Order's largest six Metropolitan Statistical Areas' (MSA)s are located from 95 miles to 311 miles from the nearest city with a Southeast Federal Order No. 1007 distributing plant. These MSA's are located from 140 miles to 356 miles from the second nearest city with a Southeast Federal Order No. 1007 distributing plant. The Southeast Federal Order No. 1007 largest six MSA's are located from 112 miles to 477 miles from the nearest city with an Appalachian Federal Order No. 1005 distributing plant. These MSA's are located from 140 miles to 581 miles from the second

nearest city with an Appalachian Federal Order No. 1005 distributing plant. Eight of the twelve largest MSA's in the proposed Southeast Order marketing area are within the normal distribution distance of the nearest pool distributing plant located within the marketing area of the other Order, signifying significant and substantial overlap in the sales area of the proposed Southeast Order. (Exhibit 48 Item 29)

Two-thirds of the largest population centers in the combined marketing area fall along the corridor of competition which currently is the border of the two Orders. (Exhibit 48, Item 30) That corridor is graphically shown in Exhibit 48 Item 31. The existence of such a significant area of fluid milk sales competition suggests the removal of the border between the Orders, not the preservation of such a border.

Within the marketing areas of the Southeast Federal Order No. 1007 and the Appalachian Federal Order No. 1005 there is substantial and significant competition for sales between plants regulated under the two Orders. Exhibit 48 Item 22 shows the location of those distributing plants located within the two Orders. Currently there are some sixteen (16) Federal Order No. 1005 pool distributing plants, of a total of 24, with Class I route disposition into the Southeast Federal Order No. 1007 marketing area while some seven (7) Federal Order No. 1007 pool distributing plants have Class I route disposition into the Appalachian Federal Order No. 1005 marketing area.

Class I disposition on routes inside the Southeast Federal Order No. 1007 area by Appalachian Federal Order No. 1005 Pool plants for the year 2003 was 11.25 percent of the total Class I route disposition by all plants in the Southeast Federal Order No. 1007 marketing area. (Exhibit 48 Item 25) Class I route disposition by Appalachian Federal Order No. 1005 Pool

plants was 63.9 percent of the total Class I route disposition in the Southeast Federal Order No. 1007 marketing area by all non-pool plants. (Exhibit 48, Item 25) When considering Class I route disposition into the nearby and adjacent area, that is Western Kentucky, Nashville, TN., Northern Alabama, Atlanta, GA., and Savannah, GA., of the Southeast Federal Order No. 1007, Class I route disposition by Appalachian Federal Order No. 1005 pool plants could equal as much as one-fourth of the total route disposition in that nearby and adjacent portion of the Southeast Federal Order No. 1007 marketing area.

Class I route disposition in the Southeast Federal Order No. 1007 marketing area by Appalachian Federal Order No. 1005 pool plants has increased by 11.1 percent since January 2000. Each year-to-year comparison also shows an increase in this relationship. The increase was 5.9 percent in 2001 from 2000; 2.1 percent in 2002 from 2001; and 1.9 percent in 2003 from 2002.

For the month of December 2003, the 52 pool distributing plants that are expected to be fully regulated under the proposed Southeast Order supplied 94.11 percent of the total Class I route disposition by all plants within the proposed Southeast marketing area. (Exhibit 48 Item 25)

Class I route disposition by pool plants averaged over 94 percent for each of the years 2000, 2001, 2002, and 2003. (Exhibit 48, Item 25) This high a percentage supplied by pool plants indicates that the proposed Southeast marketing area is an extremely self-reliant marketing area in terms of Class I processing and distribution; with only slightly more than five percent of total route disposition within the marketing area that would be delivered from nonpool plants.

As previously stated, 11.25 percent of the route disposition in the current Southeast Order

marketing area came from Appalachian Order pool plants during 2003, representing almost two-thirds of the route disposition in the current Southeast Order marketing area from all nonpool plants. The route disposition association, or overlap, from Order 5 pool plants into the Order 7 area exceeds the portion of route disposition into other nearby or adjacent Orders from all nonpool sources. Exhibit 48 Item 32 shows the portion of all route dispositions in the marketing areas from all nonpool sources for the Florida, Northeast, Central, Mideast and Southwest Federal Orders for the month of November 2003. The route disposition portion of Order 5 plants into the Order 7 marketing area exceeded the portion of route disposition from all nonpool sources into the Northeast Order area at 3.4 percent from all nonpool sources, the Mideast Order area at 6.8 percent from all nonpool sources, the Southwest Order area at 7.1 percent from all nonpool sources, and approached the amount distributed in the Florida Order which had 12.7 percent of its total route disposition from all nonpool sources. Only the Central Order had significantly greater route disposition from all nonpool plants than did Order 5 plants have into the Order 7 area.

Located within the current Appalachian Federal Order No. 1005 is a distributing plant which has a greater proportion of its total Class I route distribution into the Southeast Federal Order No. 1007 marketing area than into the Appalachian Federal Order No. 1005 area. The plant remains “locked in” as a pool plant under the Appalachian Federal Order No. 1005 so long as it maintains at least 25 percent of its total Class I route disposition into the Appalachian Federal Order No. 1005 marketing area.

Overlapping areas of milk supply: This criterion applies principally to areas in which major proportions of the milk supply are shared between more than one Order. The competitive factors affecting the cost of a handler’s milk supply are influenced by the location of the supply.

The pooling of milk produced within the same procurement area under the same order facilitates the uniform pricing of producer milk.

There is a substantial and significant overlap of the supply of producer milk for the current Appalachian Federal Order No. 1005 and the Southeast Federal Orders No. 1007. As shown in Exhibits 7–10, and Exhibit 48, over the past four years, producers located within the marketing areas of the two Orders in southern Indiana, central Kentucky, central Tennessee, central North Carolina, western South Carolina, and central and southern Georgia have supplied milk to plants regulated under each of the two Orders. Outside the marketing areas of the two Orders, producers located in northwestern Indiana and south central Pennsylvania have also supplied milk to plants regulated under each of the Orders. The Southern Marketing Agency's knowledge of the market tells us that nearly all of the milk produced within the Marketing area stays within the boundaries of the proposed Southeast Order -- not that remarkable since the area is a deficit market.

For the month of December 2003, producers located in 28 states supplied milk to either the Appalachian Order No. 1005 or the Southeast Order No. 1007 pool handlers. Producers from 16 of these states supplied milk to both Appalachian and Southeast Order handlers with 13 of these states located wholly or partially within the proposed Southeast marketing area. For December 2003, 72.54 percent of the producers were located within the proposed Southeast marketing area. (Exhibit 48.Item 16)

For the month of December 2003, producer milk located in 28 states was supplied to either the Appalachian Order No. 1005 or the Southeast Order No. 1007 pool handlers. Producer milk from 16 of these states supplied milk to both Appalachian and Southeast Order handlers.

For December 2003, producers who are located within the proposed Southeast marketing area supplied 53.14 percent of the producer milk, but these producers represented 72.54 percent of the number of producers supplying the Order. (Exhibit 48, Item 17) Obviously the producer milk pooled on the Orders from outside the marketing area originates on farms of larger than the average size for all producers on the Orders. Of the milk supplied from outside the marketing area much of it came from a few pockets of milk supply – populated by large farms. Much of this “out of area reserve supply” is delivered regularly to handlers in both Orders. Adoption of Proposals 1 and 2 would make this supply function operate more efficiently and with lower costs.

Number of handlers within a market: Formation of larger-size marketing areas is a stabilizing factor. Shifts of milk and/or plants between Order markets become less of a disruptive factor in larger markets. Also, the existence of Federal Order markets with handlers too few in number to allow meaningful statistics to be published without disclosing proprietary information should be avoided.

As previously shown, during the month of December 2003 there were 52 distributing plants that were regulated under the Appalachian Federal Order No. 1005 or the Southeast Federal Order No. 1007. These are the same distributing plants that are expected to be pool distributing plants under our proposed Southeast Federal Order No. 1007. Fifty of these plants are located within the proposed Southeast marketing area with the remaining two located in the unregulated area of the state of Virginia.

The combination of the two Orders into the proposed Southeast Order will provide stability within the area, will minimize the shifting of milk and/or plants between markets and will foster the release of meaningful statistics without disclosing proprietary information.

Natural boundaries: Natural boundaries and barriers such as mountains and deserts often inhibit the movement of milk between areas, and generally reflect a lack of population (limiting the range of the consumption area) and lack of milk production. Therefore, they have an effect on the placement of marketing area boundaries. In addition, for the purposes of market consolidation, large unregulated areas and political boundaries also should be considered a type of natural barrier.

The marketing area of the proposed Southeast Federal Order No. 1007, as depicted in Exhibit 48 Item 12, shows that a substantial portion of the boundary of the proposed marketing area is formed by natural boundaries or barriers. To the south is almost 600 miles of coastline along the Gulf of Mexico; to the East is almost 600 miles of the coastline of the Atlantic Ocean; and, to the north are the unregulated areas of central Missouri, West Virginia, and Virginia.

Cooperative association service areas: Cooperative membership is an indication of market association and provides support for the consolidation of marketing areas. The proposed Southeast Federal Order marketing area represents the service area of the Southeast Council of Dairy Farmers of America, Inc. For the month of December 2003, DFA member producer milk represented 48.9 percent of the total producer milk and 58.0 percent of the producers that were pooled on the Appalachian Federal Order 1005 and the Southeast Federal Order 1007 and therefore would have been pooled on the proposed Southeast Order. (Exhibit 48, Item 27)

As previously discussed, the proposed Southeast Federal Order marketing area represents the service area of the Southern Marketing Agency, Inc. For the month of December 2003, SMA's cooperative member milk represented 66.22 percent of the total producer milk and 72.31

percent of the producers that would have been pooled on the proposed Southeast Order.(Exhibit 48 Item 27)

Also, during the month of December 2003 there were 8 other cooperatives, other than SMA cooperatives, that would have had member milk pooled on the proposed Southeast Order. Of these eight, 5 were delivering milk to, or for the account of, an SMA member cooperative.(Exhibit 48 Item 27)

The cooperatives represented by the Southern Marketing Agency, Inc. for the month of December 2003, marketed 62.32 percent of the total producer milk pooled on the Appalachian Federal Order No. 1005 and 69.68 percent of the total producer milk pooled on the Southeast Federal Order No. 1007. On a combined order basis, including the other cooperative milk marketed by a Southern Marketing Agency, Inc. cooperative, the Southern Marketing Agency, Inc. cooperatives would have marketed approximately 78 percent of the total producer milk that would have been pooled on the proposed Southeast Order.

Provisions common to existing Orders: The regulatory provisions of the Appalachian Federal Order No. 1007 and the Southeast Federal Order No. 1007 are similar in most all respects except for the qualification provisions for producer milk and a producer. Here, they differ only slightly.

While not a Federal Milk Marketing Order regulatory provision, the common pooling of costs and returns for member milk that would be pooled on the proposed Southeast Order by the Southern Marketing Agency, Inc. cooperatives does recognize similar marketing conditions within the proposed Southeast Order area and provides further justification for the consolidation of the Appalachian and Southeast Orders.

Milk utilization in common dairy products: Utilization of milk in similar manufactured products has been considered to be an important criterion in determining the consolidation of existing Federal Milk Marketing Orders. The difference in the Class I utilization under the Appalachian and Southeast Orders, except for some seasonal variations, has remained relatively unchanged in 2001, 2002, and 2003. The difference was 5.08 percent for the year 2001; 4.49 percent for the year 2002; and 4.89 percent in 2003.(Exhibit 48, Item 33)

For the year 2003, the Class II, III, and IV utilization under the Appalachian Federal Order No. 1005 was 14.41, 7.11, and 8.12 percent respectfully while utilization under the Southeast Federal Order No. 1007 was 9.97, 17.79, and 6.78 percent respectfully. Class II and Class IV usage predominates under the Appalachian Federal Order while Class III usage is predominate under the Southeast Order. (Exhibit 48, Item 33)

A significant portion of the Class II usage difference between the Appalachian Federal Order and the Southeast Federal Order can be accounted for by the fact that there are at least three Appalachian Order distributing plants that are significant producers of Class II products that are distributed in the Southeast Federal Order marketing area.

The higher usage of producer milk in Class III under the Southeast Federal Order is the direct result of the usage of surplus milk in the major production areas of southern Missouri and northern Arkansas. Reserve milk disposition in these areas is primarily in cheese. However, during the peak surplus disposal periods all seasonal balancing capacity is fully utilized regardless of product classification. So it seems reasonable that since all of the market uses and needs this capacity at the peak balancing period it should also share the returns equally during the remainder of the year.

Summary. When the criteria for market consolidation, as identified and applied in the final decision for federal order reform, are reviewed, a clear and compelling case for merger of current Orders 5 and 7 is established. The areas of handler distribution overlap and producer supply overlap are quite striking. The orders are both supply deficit, high Class I utilization orders and they are being served by one cooperative marketing agency as a unified market. Proposals 1 and 2 should be adopted.

4. What Would a Merger Achieve?

The proposed consolidation of the Appalachian Federal Order No. 1005 and the Southeast Federal Order No. 1007, creating a new Southeast Federal Order No. 1007, would result in a number of significant improvements in marketing conditions in the Southeast.

Blend price uniformity. Consolidation of the Appalachian and Southeast Orders would resolve a disruptive producer blend pricing issue which currently occurs in the common supply areas of the Appalachian and Southeast Orders. With similar Class I utilizations under the two orders, such a divergence of producer blend prices is primarily the result of the differences in Class II, Class III, and Class IV usage under the two Orders. Class II and Class IV usage predominates under the Appalachian Order while Class III usage is predominant under the Southeast Order. Because of different prices for each Class, the contribution to the order blend price varies substantially between the two Orders.

Measuring blend price disparities with percentage differences in blend prices trivializes the actual per-hundredweight differences, and those per-hundredweight differences' impact in the numerous areas of overlapping producer milk procurement. The simple average of the Southeast Federal Order 1007 blend price for the 48 months since Order consolidation is \$14.057, and is

\$14.274 for the Appalachian Federal Order 1005. The average per hundredweight difference is \$0.217, but that is less than two percent of either the Southeast Federal Order 1007 blend price or the Appalachian Federal Order 1005 blend price. (Exhibit 48, tem 35) While a two-percent difference in uniform price may seem nominal, a longstanding blend price difference of this magnitude on a per hundredweight basis would generally be considered sufficient to convince dairy farmers to seek to switch markets.

In those areas where producer milk is procured for both Orders, over-Order prices paid by plants procuring from nonmembers will likely be unequal, resulting in unequal Class I costs. Why would an Appalachian Federal Order No. 1005 handler pay the same premium as a Southeast Federal Order 1007 handler competing in the same area, when the Appalachian Federal Order 1005 handler starts at a \$0.217 higher blend price? Conversely, the Southeast Federal Order No. 1007 handler must make up the difference between the Order 5/7 blend in the form of an over-order premium if the handler desires to retain its producers. Unequal Class I costs can be, and typically are, an element of disorderly marketing.

Blend price differences are a product of Class I utilization differences and many other factors. Those other factors can be: Class I price differences; utilizations in the other classes; prices of the other classes; inventories; overages; the effect of handler and producer location adjustments on the base zone blend price; skim/butterfat utilization differences; rounding in the pool; and other factors. It seems to us that the differences in blends which exist between the Appalachian Federal Order 1005 and the Southeast Federal Order 1007 are greater than one would expect using our previous years figuring method. That would be, all things being equal, a five percent difference in Class I utilization would generate about a \$0.155 per hundredweight

difference in blend prices between the Appalachian Federal Order 1005 and the Southeast Federal Order 1007.

The simple average of the monthly Class I utilizations of the Appalachian Federal Order No. 1005 for the 48 months since consolidation is 67.96 percent, and is 63.43 percent for the Southeast Federal Order No. 1007, a simple difference of 4.53 percent. (Exhibit 48, Item 35) Our previous years figuring method would yield an expected blend difference of \$0.140 per hundredweight vs. the \$0.217 we have seen. This exhibit shows that the blend price differences have indeed been greater than the percent Class I utilization differences would suggest. Something else is going on, and that something is largely producer milk use differences in the lower priced classes of utilization. All Federal Milk Marketing Orders have similar Class III and IV classifications and pricing so that the market returns can be shared equitably between producers delivering to powder plants and to cheese plants, when market returns on those sales can be vastly different. Because Order 5 and 7 are a single common market the returns from Class III and Class 4 should also be shared equally.

A distinction can be drawn, or rather should be drawn, on the difference between market balancing and market driven demand. The majority of the Class III production in the Southeast Order 1007 is not particularly determined by available milk supplies, which defines market balancing, but rather is processed to supply demand sales. The volume of milk going to Class III does not vary as much seasonally as does the supply of milk vary seasonally, which is the appropriate statistic in measuring what product(s) are used for market balancing.

The variation in processing into hard products in the Southeast Order 1007, and in the Appalachian Order 1005, is in milk used to produce Class IV. Both the Appalachian and the

Southeast Orders use butter-powder as their balancing products. It is the existence of the Class III demand component in the Southeast Order 1007 as a contributor to the blend price differences between the Orders which is significant.

Integration of Class I sales areas. Consolidation of the Appalachian and Southeast Orders would recognize the inter-order competition for Class I sales within the Appalachian Federal Order No. 1005 and the Southeast Federal Order No. 1007 marketing areas - primarily within the eastern portion of the current Southeast Federal Order No. 1007 area. There is more competition for Class I sales in this area between Southeast Order 1007 plants and Appalachian Order 1005 plants than there is between Southeast Order 1007 plants in that area and Southeast Order 1007 plants located in the western portion of the Southeast Order 1007 marketing area.

Exhibit 48 Item 41 graphically demonstrates the concentration of Class I processing and Class I sales distribution competition that exists along the current border separating Order 5 and Order 7. Each circle around a Class I processing plant location represents the normal distribution distance of a fluid milk plant, which we estimate to be approximately 250 miles. As can be seen from the Exhibit, the greatest concentration of processing plants lies along the border of Orders 5 & 7, and thus the greatest amount of sales competition lies along this border. The large magnitude of Class I route disposition from Order 5 plants into the Order 7 area previously testified to is not surprising given the location of the plants and not-coincidentally the location of population centers along the marketing Order border.

Post-Reform Federal Milk Marketing Orders are bigger and much different operational entities than pre-reform orders. Pre-reform tests of market commonality are no longer rational comparisons. The 15,000,000 pounds of packaged Class I sales from outside, in a market, which has

90,000,000 pounds of total in-area sales, may have in the past suggested Order consolidation. But what caused the problem was not the fact that it was 16.67 percent from another Order area, it is that there were 15,000,000 pounds of sales in an area and the local producers were not getting to share in the proceeds of those Class I sales. In addition, the producers supplying the milk which went into those 15,000,000 pounds were not sharing in the Class I proceeds in the rest of the market where those 15,000,000 pounds were being distributed.

In our view, the 15,000,000 pounds is the important number, rather than the 16.67 percent. Those same 15,000,000 pounds are still problematic, and no less so now that they are divided by 400,000,000 pounds. It is the same marketing disorder, even if the statistic is different. The same principle applies for producer milk procurement overlap. The problem revealed by the actual numbers should not get lost in the enormity of the current market fraction's denominator.

The sheer size of current Federal Order marketing areas makes percentage comparisons of in-area sales volume a difficult statistic to quantify as a determining factor in the need to merge Order areas. Total in-area route disposition in the Southeast Order 1007 area currently approximates 400 million pounds per month. (Exhibit 48, Item 25) Requiring twenty percent of that total to signal consolidation with another Order would require 80,000,000 pounds of in-area route disposition from that other Order, a number unlikely to be achieved under almost any conditions.

Similarly, the average monthly producer milk pooled on the Appalachian Order 1005 is approximately 526 million pounds. (Exhibit 48 Item 22) If 80,000,000 pounds of Class I route disposition into the Southeast Order 1007 area from the Appalachian Order 1005 pool plants were deemed required for a level of material overlap, 13.9 percent of the producer milk pooled

on the Appalachian Order 1005 would be sold on routes in the Southeast Order 1007 area. This simply would be too high a standard to meet, virtually anywhere in the country.

Additionally, using a simple computation of Class I disposition on routes from one Order, divided by the total Class I route sales in another Order, implies that route sales are evenly distributed across the entire Order area. Such is certainly not the case in either the Appalachian Order 1005 or the Southeast Order 1007. The concentration of population along the Appalachian Order 1005 and the Southeast Order 1007 border is greater than the concentration anywhere else in the Appalachian Order 1005 area or the Southeast Order 1007 area. Overlapping sales and supplies in that critical corridor of competition should be assessed standing alone to determine the merits of the proposed merger.

Common supply areas. Consolidation of the Appalachian and Southeast Orders would recognize the extent of the common supply area for the current Appalachian Order 1005 and the Southeast Order 1007. For the month of December 2003, this common supply area covered 16 states including Alabama, Florida, Georgia, Indiana, Kentucky, Louisiana, Mississippi, Missouri, North Carolina, South Carolina, Tennessee, and Virginia within the proposed Southeast marketing area. (Exhibit 48, Item 16)

The singularity of these Orders as one market is also demonstrated in an analysis of the supplies to the region from out of the area. The seasonal milk shift data, (Exhibits 15–18 (Order 5) and 34–37 (Order 7)), shows there are greater shifts of milk onto the Appalachian Order 1005 and the Southeast Order 1007 from Order 1, Order 32, Order 33, and Order 126 than shifts between and among the Appalachian Order 1005 and the Southeast Order 1007; and, sources of milk from outside the individual Order areas are greater from Order 1, Order 32, Order 33 and

Order 126 than from the adjoining Appalachian Order 1005 and the Southeast Order 1007. While this data at first blush might be viewed as suggestive that consolidation of the Appalachian Order 1005 and the Southeast Order 1007 is thus contraindicated, the reverse is actually true.

Both the Appalachian Order 1005 and the Southeast Order 1007 are deficit milk markets. The monthly milk deficits in the Southern Marketing Agency in 2003 ranged from approximately 43 million pounds in April to 270 million pounds in August⁴. The monthly demand figures does not include any monthly balancing reserve. It must be noted again that only the Orders in the Southeast have insufficient in area milk production to meet Class I needs and a reasonable reserve: Virtually all of the milk produced within the marketing area is already serving demand customers, predominantly Class I. In addition, current producer qualification requirements of the Orders, that is touch base requirements, limit the movement of milk within the proposed Southeast Order area. In this situation, procuring milk within the area yields no "net" gain and may result in qualification complications. As a consequence, both Orders are going to go outside the area, for supplemental supplies

Movement of producer milk. Consolidation of the marketing areas would allow producer milk to move more freely between pool plants within the proposed Southeast marketing area. Due to producer and producer milk qualification provisions of the individual Orders, milk may not shift from one Order to the other when needed.

⁴ The Southern Marketing Agency milk budget showed a member milk deficit each and every month of 2003. These numbers include in the regular, non-deficit supply Southern Marketing Agency member milk supplies geographically located outside the Appalachian Order 1005 and the Southeast Order 1007 marketing areas.

A substantial portion of the milk supply situated within the proposed Southeast Order would become more available for use by pool plants located in either of the two current marketing areas. However, while there is producer milk which moves between and amongst the two Orders, the producer qualification criteria of the two Orders as they currently exist form a regulatory barrier to the free and efficient movement of this milk. In effect, the producer touch-base requirement for market association and diversion qualification is additive as the two Orders exist today. That is, in order to insure producer qualification on a producer which may be efficiently and effectively pooled on either of the two current Orders, the producer touch-base requirement in the short-supply months is, in actuality, 16 days per month. That is the six days required in the Appalachian Order plus the 10 days required in the current Southeast Order. Also there is a cumulative nature to the computation because if you lose association with one market you must start over again.

Additionally, the requirement that a producer re-associate with a Federal Order market by being physically delivered to a pool plant limits flexibility and efficiency in milk movements. A producer whose milk can be easily shifted between distributing plants in the current Order 1005 area and the current Order 1007 area is treated in this re-association matter as if the producer was off one of the markets for some reason other than the supply of milk to a nearby Class I plant. For example, a producer located in central Tennessee can equally reach either the distributing plants located in either the Nashville area or the Knoxville-Athens-Chattanooga corridor. As the Orders exist today, these producers must be assigned to one of the two Orders on a monthly or seasonal basis, and if the producer is shifted between the Orders, must re-associate with the producer's "home" Order by delivery to a pool plant prior to diversion, even though the producer

was supplying a distributing plant only a short distance away and which likely is supplying Class I packaged fluid milk in the area in which the producer is located. This amounts to a regulatory limit on the efficient delivery of producer milk to a common Class I market.

Costs of balancing would be equalized. Consolidation of the Appalachian and Southeast Orders would resolve a disruptive practice whereby the Southeast Order 1007 carries some of the balancing cost of supply for the Appalachian Order 1005. Producer milk may shift from the Southeast Order pool to the Appalachian Order pool in the fall months to partially supply the needs of Appalachian pool plants.

Some milk does shift, but why does more milk not shift between the Appalachian Order 1005 and the Southeast Order 1007 to cover seasonal demand shifts? The answer is, there just isn't any milk left to move. It's all serving a local demand market.

In order to cover the monthly milk production deficits and provide even a modest reserve, milk must be procured from outside the market. If you're looking for milk supplies you just don't look to a place that is also looking for milk. You look to the places that have some extra. This is another reason why you don't see major milk movements between the Appalachian Order 1005 and the Southeast Order 1007.

Cooperative servicing areas. We need to erase the line that artificially separates a common milk market. While "cooperative service area" may be a small or secondary point in the consolidation-decisional process the Secretary has used in the past, the way a market is supplied and the industry's view of what constitutes a common milk market must be considered. Perhaps the salient question is "where else in the Order system is there a single marketing agency in

common, like Southern Marketing Agency, Inc., which serves what constitutes the vast majority of two Orders as if they are one?”

Southern Marketing Agency, Inc. includes as part of its operational area portions of the Central and Southwest Orders, and the unregulated portion of Virginia in addition to the majority of the Appalachian Order 1005 and the Southeast Order 1007. The Greater Southwest Agency encompasses part of the Central Order with the Southwest Order in its operational territory, but in no way takes in even the majority of the Central Order (Order 32). We know of no other circumstance such as exists in the Southeast where a single marketing agency in common and its supply of milk to a market is split down the middle by a Federal Order boundary. Rather, the converse seems to be more often true. That is, there are multiple agencies supplying or pricing milk in a part of what is now a single order.

In addition to the SMA itself, consolidation of the Appalachian and Southeast Orders would reflect the membership area of the Southeast Council of Dairy Farmers of America, Inc. in that its area of coverage corresponds to the proposed Southeast marketing area. As shown in Exhibit 48, Item 27, Southern Marketing Agency Inc. Number of Producers and Producer Milk Deliveries, Appalachian 1005 and Southeast 1007, December 2003, Dairy Farmers of America, Inc. represents 58.0 percent of the producers and 48.9 percent of the producer milk that would be pooled on the proposed Southeast Federal Order 1007.

Recognition of existing common pooling. Consolidation of the Appalachian and Southeast Orders would recognize the Southern Marketing Agency, Inc. common pooling of costs and returns across the proposed Southeast marketing area. Southern Marketing Agency, Inc. cooperative membership represents 72.31 percent of the number of producers and 66.22

percent of the producer milk that would be pooled on the proposed Southeast Federal Order 1007. (Exhibit 48 Item 27) Exhibit 48, Item 36 illustrates the scope of the Southern Marketing Agency. For the year 2003 that volume averaged 951.8 million pounds per month.

Comparison of the Southern Marketing Agency, Inc. pool with the volume of producer milk expected to be pooled on the proposed Southeast Order 1007, as shown in Exhibit 48 Item 22 demonstrates that the SMA pool for 2003 represented a volume equal to 85.3 percent of the proposed Southeast Order pool.

No new parties to be regulated. Consolidation of the Appalachian and Southeast Orders will, as best we can determine, not result in the regulation of any additional parties under the proposed Southeast Federal Milk Marketing Order 1007.

5. Options to merger do not do the job.

Proponents thoroughly reviewed and considered options to full merger of the orders which might be seen as lesser regulatory fixes. After full consideration, those options were found wanting. Three options are worthy of mention.

Merger of the transportation funds was considered. This would directly address the inequity of payout and assessment rate from the present separate funds. However, it would not address the blend price inequities on the producer side. It would also not increase logistical efficiencies in the pooling and association of producer milk. In addition, it is not clear that the AMAA authorizes a blended or joint transportation pool fund from two separate marketing orders. In the final analysis, the same logic which justifies merger of transportation funds for uniformity and efficiency in supplying the Class I market also justifies full merger of the orders.

Reciprocal producer qualification was also evaluated. This would allow qualification for diversion on one order to serve the other order as well. This would alleviate some logistical inefficiencies and bottlenecks. However, it would not address blend price inequities or correct Class I cost differences. Also, it would increase geometrically the possibility of pooling errors and audit adjustments; it could be a nightmare for the market administrators. It would also increase the opportunities for pooling schemes which are not market service oriented. Again, in the final analysis, the same logic which would justify reciprocal producer qualification justifies merger of the orders. If a producer, by qualifying on one order is qualified on the other order, are they not in actuality one market?

Finally, SMA has considered pooling changes to equalize the blends. If SMA were sufficiently prescient to know utilization rates and class prices, it could conceivably come close to equalizing the blend prices on the orders by pooling milk supplies to accomplish that end. However, this would be logistically inefficient, requiring movement of milk solely for purposes of pooling and not for supply efficiency. There would be uneconomic movements of milk to try to balance blend prices. The project would be, at the very best, a quite inexact science since Class III and IV prices are not known during the month and utilization rates are speculative. In the end, this self-help solution to blend price differences does not recognize the essence of the integrated milkshed and overlapping supplies and does nothing for the handler cost issues embedded in the separate transportation funds in the separate orders.

In summary, SMA sees no alternative to full order merger, and the hearing record discloses no alternative which would address the compelling issues of marketing disorder and inefficiency which it now faces in the Southeast.

B. Terms of the merged Order should be tailored to current marketing conditions.

There are a number of terms of a proposed order which need to be updated and tailored to meet current marketing conditions of the southeastern marketing area. Also, there are certain administrative provisions for consolidation which need to be addressed. The producer milk, pool plant, and transportation credit provisions need to be updated for current marketing conditions. The funds involved in administration of the order, including the transportation credit funds, need to be combined. We will discuss these several issues in turn.

1. Revised Producer Milk Provisions. The proposal to modify certain paragraphs of section 1007.13 Producer Milk converts the “touch base” requirements of the provision from a number of “days” production basis to an equivalent “percentage” of production basis. In addition, the proposal changes the day of the month on which milk of a dairy farmer shall be eligible for diversion. The latter provision would provide that a dairy farmer shall be eligible for diversion the first day of the month during which the milk of the dairy farmer meets the “touch base” requirements of the Order. These provisions are deemed necessary in order to accommodate the advent of large dairy farms that ship multiple loads of milk per day. Previous testimony has demonstrated that the distant milk supplies, which provide a significant portion of the markets’ reserve, originate from farms that on average produce more milk per month than do the producers located within the proposed marketing area.

Under a Federal Milk Marketing Order it is necessary to designate clearly which milk will be subject to the various provisions of the proposed Order. The Order accomplishes this by defining specific terms that describe the persons, that is producers, whose milk will be subject to the uniform prices.

The term 'producer' defines those dairy farmers who constitute the regular source of supply for the Order. Producer status under the proposed order is provided for any dairy farmer who produces milk approved by a duly constituted regulatory agency for fluid consumption as Grade A milk and whose milk is received at a pool plant directly from the producer's farm or is picked up at the farm by a cooperative as a bulk tank milk handler for delivery to a pool plant. Producer status is also accorded to a dairy farmer who has an established association with the market and whose milk is diverted from a pool plant to a nonpool plant by a cooperative association or a pool plant operator.

To establish a producer's association with the market, our proposal requires that a dairy farmer's milk must be delivered to a pool plant each month to qualify such dairy farmer's milk for diversion to a nonpool plant.

The 'producer milk' definition, Section 13 of the proposed Southeast Federal order, defines the milk that will be priced and pooled under the Order. Specifically, the provision deals with the minimum receipt requirements of individual producers and with allowable diversions of producer milk pooled on the Order.

As previously stated, a Federal order must contain minimum performance standards in order to determine what milk should be pooled and share in the marketwide equalization associated with the Class I sales. Our proposed 'producer milk' definition is intended to both assure that milk pooled on the proposed Southeast Federal Order is closely associated with fluid use in order to qualify for pooling and to assure that each producer who shares in the blend price performs for the market.

The minimum requirements included in our proposal are virtually the same as now contained in the current Southeast Federal Order 1007. However, the ‘touch base’ requirements have been converted from a “days” production to a “percentage” of production basis.

Proposal 1 would require that each individual producer deliver 15 percent of his production to a pool plant in each of the months of January through June and 33 percent of his production to a pool plant in each of the other months of July through December. A 15 percent requirement is equivalent to about 4.5 days production while a 33 percent requirement is equivalent to about 10 days production.

This requirement of a dairy farmers' milk being physically delivered to a pool plant is included so as to have some direct association between the producer each month and a pool plant of the proposed Southeast Order. Without a provision of this kind, milk of a producer could be pooled without ever having to come to a pool plant. The provision indicates that the milk of that producer is associated with a pool plant of the order at least part of the month while still providing for the efficient handling of the milk. Milk can be diverted direct from the farm to a nonpool plant for all other times of the month if not needed at the pool plant.

If a producer's milk is not needed and not associated with the market for at least 33 percent of the producer's production during the fall months of July through December, then that producer should not be considered as part of the regular supply of milk for the fluid needs of the order. A 33 percent of production standard is a reasonable minimum requirement for associating an individual producer's milk with the marketwide pool during the short production months.

First of all, milk is at peak demand on Wednesdays, Thursdays, and Fridays of each week. Since every month has at least four Wednesdays, Thursdays, and Fridays, a producer's milk

would have to be brought in for only the days on which the Class I needs of the order pool plants are at a peak in order to meet the minimum delivery requirements.

Without delivery requirements for individual producers, it would be far too easy for the operator of a pool plant to associate enough milk with the order pool so that utilization would always be at the minimum permitted under the order. Marketing conditions in the proposed Southeast area, as reflected by the Class I utilization percentage of the orders (see Exhibit 48, Item 33; and Exhibit 48, Item 35) support the 33 percent of production delivery requirement for the short production season. If producers are to be considered as part of the necessary and reserve supply of milk for the order, then 33 percent of their production should be brought in during the fall months. Our experience in the day-to-day operations of the market would support the proposal that at least 33 percent of a producer's monthly production during the fall months is a reasonable standard in order to be able to share fully in the Class I utilization of the marketwide pool.

The SMA proposal does not change the total amount of producer milk that may be diverted by the operator of a pool plant, or a cooperative association, to nonpool plants during the month. Our proposal would continue the current provisions of the Southeast Order that limit diversions to nonpool plants to a volume equal to thirty three percent of the producer milk that is physically received at pool plants as producer milk of such handler during the months of July through December, and 50 percent in the other months.

Marketing conditions based on historical trends (see Exhibit 48, Item 35) indicate that the average Class I utilization of the proposed Southeast Order during most of these months will probably exceed 67 percent. A high utilization necessitates that the milk pooled on the order during

these months be made available for fluid use. These proposed limits in line with historical requirements, will permit the efficient disposition of milk that is not required at pool plants for fluid use.

Finally, a new provision, 1007.13(d)(6), in the Order should provide that milk of a dairy farmer shall be eligible for diversion the first day of the month during which the milk of such dairy farmer is physically received as producer milk at a pool plant and the dairy farmer meets the delivery requirements of the proposed Southeast Order. The current Southeast Federal Order 1007 follows a procedure that does not make the dairy farmer eligible for diversion until the first day after the milk of the dairy farmer is received as producer milk at a pool plant unless the milk of the producer was associated with the Order 7 pool at the end of the previous month. Application of this our proposal across the proposed Southeast Federal Order 1007 will promote efficiency in the delivery of a dairy farmers milk to the market.

2. An Updated Transportation Credit Fund: As a result of the need to import milk to the Southeast from many areas outside the Southeast during certain months of the year, transportation credit provisions were incorporated in the Appalachian Federal Order 1005 and the Southeast Federal Order 1007 as they were in the previous 4 orders reformed January 1, 2000 into the current Appalachian and Southeast orders. These provisions provide credits to handlers who incur additional costs to import supplemental milk for fluid use for markets during the short production months of July through December. The provisions restrict the use of credits by handlers to milk received from producers and plants located outside of the marketing areas. The credits are also restricted to milk received from producers who supply the markets only during the short season and are not applicable to milk of producers who supply the market throughout

the year. In addition, producers currently located within either of the Order 5 and Order 7 marketing areas are ineligible for transportation credits on either Order; that is each of Order 5 and 7 recognizes producers located within the marketing area of the other Order to be a part of the regular supply for the Southeast region. In this provision, the Secretary has already established the inextricable supply relationship between Orders 5 and 7, and the commonality of supply for the orders. This concept is not new. Its underlying rationale is discussed in the decision that instituted transportation credits in 1996.⁵ The Secretary has, through this recognition of the Southeast as a common market with regard to supply, signaled the need for the consolidation of the two orders. Proposal No. 1 simply extends that recognition to provide a common uniform price and terms of trade for all producers delivering to the market and a common set of producer qualification requirements for the market.

SMA proposes that the transportation credit provisions be retained in the proposed Southeast Federal Order but modified to reflect the consolidation of the two individual orders. Those modifications, as outlined in our proposed revisions of Section 1007.82 are as follows: First, revise paragraph (c)(1) to remove the exception "except Federal Order 1005". This is necessary since all of the Federal Order 1005 area would be merged into the new Southeast Federal Order 1007 marketing area. This is a conforming change and the exception is no longer necessary or appropriate. Second, revise paragraph (c)(2)(ii) to incorporate a temporary proviso which would provide for the equitable implementation of the transportation credits under the proposed Southeast Federal Order 1007 should the effective date of the merger be after the month of January. The temporary provision would provide that any dairy farmer who qualified for payments under the provisions of the former

⁵ Final Decision, Docket Number AO-388-A9, et al.; DA-96-08.

Appalachian Federal Order 1005 or the former Southeast Federal Order 1007 shall continue to qualify under these provisions of the consolidated Southeast order through the following January. Absent this provision, some producers who qualify for transportation credits under the current Appalachian Federal Order 1005, and who had the previous year qualified for such payments under the current Southeast Federal Order 1007, would not be eligible, pursuant to this section, to receive transportation credit payments under the proposed consolidated Southeast Federal Order 1007.⁶

Third, revise paragraph (c)(2)(iii) to remove the words “or the marketing area of Federal Order 1005”. This again is necessary since all of the Federal Order 1005 area would be merged into the new Southeast Federal Order 1007 marketing area. This is a conforming change and the exclusion is no longer appropriate.

Southern Marketing Agency, Inc. also supports the following modification to Proposal No. 1. In section 1007.81 amend the current maximum rate of assessment for the Transportation Credit Balancing fund from the current maximum of \$0.070 per hundredweight to \$0.100 per hundredweight. There is substantial evidence in support of this modification and amendment.

The current maximum rate of \$0.070 per hundredweight, which has been the rate assessed by the Market Administrator since the current Southeast Federal Order 1007 was formed, has been insufficient in the current Southeast Federal Order 1007 to generate funds necessary to cover the claimed Transportation credits. Since the current Southeast Federal Order 1007 was formed under Order Reform in 2000, only in that year were the collections by the Market

⁶ Adoption of this provision would not be necessary should the consolidated order become effective on January 1 of any year. In that regard, January 1, 2005 or sooner would be an acceptable date to SMA for the implementation of the consolidated Southeast Federal Order 1007.

Administrator sufficient to cover the claimed Transportation Credits. In 2001, 2002 and 2003, the assessments generated were substantially short of the amount of transportation credits claimed. According to information published by the Market Administrator in the monthly Southeast Order Bulletin, claims were made for transportation credits in the current Southeast Federal Order 1007, which exceeded the available fund balance, by the amounts of \$1,096,064 in 2001; \$1,078,292 in 2002; and \$3,078,667 in 2003. The anticipated continued decline of milk production in the southeastern region, coupled with expected continued increases in demand in the region suggests the amount of supplemental milk, that is milk for which a transportation credit can be claimed, will continue to increase. As such, the deficit in the Southeast Order's Transportation Credit Balancing fund will likely continue, and will likely worsen.

The maximum Transportation Credit Balancing fund assessment rate of \$0.065 per hundredweight in the current Appalachian Federal Order 1005 has been sufficient to cover all claims for Transportation Credits to date. In fact, the Market Administrator waived the Transportation Credit Balancing fund assessment two months in each year of 2001, 2002 and 2003. However, in 2003 the balance in the Transportation Credit Balancing fund for the Appalachian Federal Order 1005 declined such that it neared the amount of claimed Transportation Credits in the latter months of the year. It is anticipated that the Market Administrator will not waive the assessment in 2004 due to the substantially lowered Transportation Credit Balancing fund balance. According to Market Administrator statistics, the Appalachian Federal Order 1005 Transportation Credit Balancing fund balance at the end of 2003 was zero.

Exhibit 48 Item 37 shows, hypothetically, based on information published by the Market Administrators for the Southeast Federal Order 1007 and Appalachian Federal Order 1005, how the balances in a merged Transportation Credit Balancing fund for the period of 2000-2003 would have appeared. The hypothetical calculation also presumes that a merged Transportation Credit Balancing fund would have carried an assessment rate of \$0.070 per hundredweight, the current maximum in the Southeast Federal Order 1007, and would not have waived the assessment any month in the four year period.

As can be seen from the exhibit, balances in a merged Transportation Credit Balancing fund would have been sufficient to pay all claims in 2000, 2001, and 2002. However, even a merged Fund, with assessments set at the current maximum of \$0.070 per hundredweight for four years, would have been insufficient to pay all Transportation Credits claimed in 2003.

The calculated hypothetical unpaid Transportation Credit claims in the merged Fund would have been \$2,889,942 in 2003. The total Class I producer milk of the combined Southeast and Appalachian Orders during 2003 was 9,070,871,486 pounds, meaning in order to cover the shortage in the Fund balance, the assessment rate would have had to be increased by \$0.032 per hundredweight in 2003, for a necessary effective assessment rate of \$0.1032 per hundredweight.

The \$3,078,667 in unpaid Transportation Credits during 2003 in the current Southeast Federal Order 1007 would have necessitated an assessment rate of \$0.13665 per hundredweight in that Order alone, which is derived by dividing the unpaid credits amount by the 4,628,998,057 pounds of Class I producer milk pooled during 2003 in the Southeast Federal Order 1007, and adding the assessed rate of \$0.070. In actuality, the assessments in the current Southeast Federal Order 1007 were barely sufficient to cover one-half the claimed Transportation Credits. Inasmuch as the balance

in the Order 5 Transportation Credit Balancing fund at the end of 2003 was in practical terms zero, the effective annual Transportation Credit Balancing fund assessment rate in the Appalachian Federal Order 1005 of \$0.054 was inadequate, since Order Number 5 carried an opening balance in the Transportation Credit fund into 2003 (a balance generated from assessments in previous years which were in excess of payments). Stated differently, Order 5 spent the entirety of its opening 2003 balance plus the entirety of the assessments collected in 2003, and still had to prorate payments in December 2003.

It is indisputable that the Southeast region needs milk from outside the region to supply its Class I needs. The Transportation Credit assessment helps shift the cost of securing those needed supplies onto the proper market segment, the consumers of Class I products. In order to maintain equity among market participants, an appropriate Transportation Credit Balancing fund system must be maintained. There are several options for correcting the current inadequacies of the Transportation Credit Balancing fund system, but only one option will correct all of the current inequities.

The assessment rate for the Transportation Credit Balancing fund in the current Southeast Federal Order 1007 must be increased in order to cover the claimed but unpaid Transportation Credits. In order to fully fund the Transportation Credit Balancing fund the assessment rate must be doubled from its current \$0.070 per hundredweight maximum. While this increase in assessments would theoretically generate enough funds to cover the claimed Transportation Credits, it would create a Class I price alignment issue with the current Appalachian Federal Order 1005. In effect Class I processors located in the same Class I price zone as described in Section 1000.51 would in actuality have unequal Class I pricing. Such is currently the case at the

difference between the current Appalachian Federal Order 1005 assessment rate of \$0.065 hundredweight and the current Southeast Federal Order 1007 assessment rate of \$0.070 per hundredweight, not counting the difference in months when the Appalachian Federal Order 1005 assessment has been waived. The current nominal difference of \$0.005 per hundredweight does not represent a material difference, but nonetheless any difference is not truly defensible.

Doubling the assessment rate in the current Southeast Federal Order 1007 would create an effective Class I price difference between the Orders on the magnitude of \$0.070 to \$0.080 per hundredweight, or more than a half cent per gallon. A difference of this size would certainly create competitive advantages and disadvantages between handlers when their stated Class I price is supposed to be the same. Such a difference in Class I cost can create competitive issues in the Class I marketplace. (See Hitchell, TR 421)

Alternatively, the current maximum rates in the two Orders can be maintained, which would preserve existing level of Class I price alignment between the Orders, but would perpetuate the inequitable differences to market suppliers in procurement costs on distant milk. Since the current Southeast Federal Order 1007 Transportation Credit Balancing fund can only fund approximately half of the claimed credits, the cost of hauling distant supplies for the Southeast Federal Order 1007 is substantially greater than for the Appalachian Federal Order 1005.

The only method available to rid the market of all of these inequities is to merge the two Transportation Credit Balancing funds. A common rate of assessment will preserve Class I price alignment, and a common pay-out rate will preserve equity in the costs of procuring supplemental supplies. Merging the Appalachian Federal Order 1005 and the Southeast Federal

Order 1007 and combining the Transportation Credit Balancing funds of the two Orders will accomplish all of these goals.

Proponents did not propose any changes to the mechanical application or computation of the Transportation Credit payments from the provisions which currently exist in Orders 5 and 7. Proponents did however offer a minor modification to the Transportation Credit provisions which would require that in order to be eligible to receive Transportation Credits, a dairy farmer may be a producer on the proposed Southeast Order for not more than 50% of that dairy farm's production in the months of March and April. The current provisions require that in order to be eligible to receive Transportation Credits, a dairy farmer may not be a producer in more than 2 months of February through May, and not more than 50% of the production of the dairy farmer was producer milk under the Order in those two months. The current Orders 5 and 7 have identical language in this regard. The modification is required because of the increasing milk deficit in the Southeast, and the increasing number of months each year that milk must be imported from outside the marketing area to meet Class I needs.

3. Section 1007.7 pool supply plants: Proponent cooperatives recommend that the proposed Southeast Federal Order retain those provisions of the current Appalachian Order 1005 which provides for the pooling of a supply plant operated by a cooperative association which such plant is located outside the marketing area but within the state of Virginia. Several of the dairy product manufacturing plants in the Southeast are "balancing plants" operated by cooperative associations. These "balancing plants" qualify for pooling based upon the performance of the cooperative association, not upon shipments from the plant alone.

A balancing plant may qualify for pool plant status based upon shipments directly from producers' farms as well as shipments from the plant. To qualify as a balancing plant, the plant generally must be located within the order's marketing area. This requirement ensures that milk pooled through the balancing plant is economically available to processors of fluid milk if needed. However, in the case of the current Appalachian Order, a cooperative balancing plant also may be located in the State of Virginia. This provision was contained in the previous Carolina Federal Order and was continued in the reformed Appalachian Order.

A primary mission of Southern Marketing Agency, Inc., is to provide milk to handlers for fluid use and to dispose of milk when not needed for fluid use efficiently. The proposed Southeast Order provision should accommodate and encourage efficient milk handling practices. Therefore, the proposed provisions of Section 1007.7(d) should be included in the proposed Southeast Federal Order.

Proponent cooperatives also recommend that the proposed Southeast Federal Order retain those provisions of the current Appalachian Order 1005 which provide for the "nonpool" status of a portion of a pool plant designated as a "nonpool plant" that is physically separate and operating separately from the pool portion of such plant.

In the current Appalachian Federal Order 1005, a pool supply plant does not include any portion of a plant that is not approved for handling Grade A milk and that is physically separated from a portion of a plant that has such approval. While some inspection agencies render only one type of approval for an operation, to accommodate those areas where split operations are permitted, the current Appalachian Federal Order 1005 provide for a physically separated portion

of the plant as a “nonpool plant.” Proponent cooperatives believe that the inclusion of this provision in the proposed Southeast Federal Order would be appropriate.

4. Section 1007.7(a) and (e) pool distributing plants. The current language in Order 7 regarding the pooling of distributing plants based on the plants being located within the marketing area should be maintained. Since the middle 1980’s distributing plants in the Southeast have been “locked-in” as a pool plant in the order in which they are physically located in a number of the predecessor Orders to the current Orders 5 and 7. The current Orders 5 and 7 provide in Section .7(e) that two or more plants operated by the same handler may qualify as pool plants, as long as together they meet the in-area and Class I utilization requirements specified in Section .7(a). There is substantial evidence to continue this procedure and for pooling distributing plants in general based on their physical location.

There is substantial competition between and among distributing plants located and pooled in the two current Order areas. An important element of total Class I milk cost to a plant is the competitive price which must be paid to producers who supply a plant or plants. Differences in milk-check prices to producers, either as a result of differences in Over Order prices or as a result of differences in the underlying Federal Order uniform prices, can result in unequal Class I milk costs to competing handlers. Differences in over order prices can in fact be a result of differences in the underlying Federal Order uniform prices. Handler Class I cost equity is most easily preserved when Federal Order uniform prices to producers are equitable and rational in light of the various plants which may be drawing from a group of producers similarly situated.

Plants located within the marketing area of the proposed Southeast Order supply approximately 95 percent of the fluid milk products distributed on routes in the proposed combined marketing area, signifying a significant and substantial amount of competition between the plants that are expected to be regulated under the proposed Southeast Order. The 5 percent of the fluid milk distributed on routes in the marketing area from other nonpool plants suggests that the competition for sales in the marketing area is predominately between the pool plants currently regulated under the two Orders. A portion of the remaining 5 percent of route disposition comes from nonpool plants located within the marketing area, leaving a very tiny slice of competition between handlers regulated under the proposed Southeast Order and handlers pooled on other Orders or partially regulated plants located outside the proposed marketing area. Since all but two of the pool plants currently regulated under the two Orders are located within the proposed Southeast Order marketing area, and the two plants located outside the marketing area are proposed to be included within the marketing area as described in Proposal Number 3, it is reasonable to conclude that those plants located within the marketing area constitute the vast majority of fluid milk sales competition, and since they are virtually all located within the marketing area, should thus be subject to the same Federal Order uniform price, subject to the same producer qualification criteria, and subject to the same pool plant qualification criteria. This would be accomplished by consolidating the two Orders and preserving the current regulatory status of plants that are located within the marketing area, but may distribute a plurality of their fluid milk outside the proposed marketing area. This problem is most typically limited to plants on the fringe of the marketing area.

Distributing plants represent a significant capital investment generally made in a large single time period and then in smaller but continuous increments over the life of the facility. From time to time market considerations such a population shifts, changes in milk shed location, consolidation in ownership of processing capacity and retail ownership can have negative (and positive effects) on the return potential of those capital investments. Lock-in provisions helps to preserve the viability of those investments for the benefit of both the distributing plant and to dairy farmers.

The current lock-in language has proved beneficial to SMA membership, marketing efforts and customer relationships and should be continued. Plants located geographically near one another typically seek supplies from a common group or groups of producers. As previously stated, disorderly conditions can occur if plants procuring milk from these common groups of producers cannot offer a commensurate Federal Order blend price. In order to insure that these plants, all of which are in competition with other plants similarly situated and which are in competition for producer supplies continue to have a common blend price, with differences based only on plant location adjustment, plants located within the proposed geographical area of the Southeast Order should be pooled together, and should remain pooled together even if they have a plurality of route disposition outside the marketing area.

In summary, all plants that are currently pool plants (both distributing plants and supply plants) under the separate Orders 5 and 7 should be afforded pool plant status under the proposed Southeast Order. The only plant for which a change in regulatory status is contemplated would be the plant impacted in Proposal Number 3.

C. Funds Should Be Consolidated in the Merger of the Orders per Proposal 2.

To complete the consolidation of the Appalachian Federal Order 1005 and the Southeast Federal Order 1007 effectively and equitably, the reserve balances in the marketing service, administrative expense, producer-settlement funds, and the Transportation Credit Balancing funds that have resulted under the individual orders should be combined.

The marketing area of the proposed Southeast Order, as described in proposal No. 1, is the same territory now covered by the two individual orders. Because of this, the handlers and producers servicing the milk needs of the individual Appalachian Federal Order market and the Southeast Federal Order market will continue to furnish the milk needs of the proposed Southeast Federal Order market.

In this regard, the reserve balances in the funds that have accumulated under the two individual orders should be combined into the appropriate fund established for the proposed Southeast Federal Order. Any liabilities of such funds under the individual orders would be paid from the appropriate newly established fund of the proposed Southeast Federal Order. Similarly, obligations that are due the separate funds under the individual orders would be paid to the appropriate combined fund of the proposed Southeast Federal Order.

The money accumulated in the marketing service funds of the individual orders is that which producers for whom the market administrators are performing such services have paid. Since the marketing area of the proposed Southeast Federal Order encompasses the territory covered by the two individual orders, the producers who have contributed to the marketing service funds of the individual orders are expected to continue supplying milk for the proposed Southeast Federal Order. Since marketing service programs will be continued for these

producers under the proposed Southeast Federal Order, it would be appropriate to combine the reserve balances in the marketing service fund of the proposed Southeast Federal Order.

The money paid to the administrative expense fund is each handler's proportionate share of the cost of administering the order. Handlers regulated under the two individual orders will continue to be regulated under the proposed Southeast Federal Order. In view of this, it would be an unnecessary administrative and financial burden to allocate the reserve funds of the two individual orders back to handlers and then accumulate an adequate reserve for the proposed Southeast Federal Order. It would be equitable and more efficient to combine the remaining administrative monies accumulated under the two individual orders in the same manner as the marketing areas are combined.

Likewise, the producer-settlement fund balances of the two individual orders should be combined. They should be combined on the same basis as the two individual marketing areas are proposed to be consolidated. This will enable the producer-settlement funds of the proposed Southeast consolidated order to continue without interruption.

The producers currently supplying the Appalachian Federal Order 1005 and the Southeast Federal Order 1007 are expected to supply milk for the proposed Southeast consolidated Order. Thus, monetary balances in the producer-settlement funds of the two individual orders now would be reflected in the pay prices of the producers who will benefit from the proposed Southeast Federal Order. The combined fund for the proposed Southeast Federal Order also would serve as a contingency fund from which money would be available to meet obligations (resulting from audit adjustments and otherwise) occurring under the two individual orders.

To complete the consolidation process, the reserve balances in the Transportation Credit Balancing funds that are in effect now under the two individual orders also should be consolidated. The reserve balances in the Transportation Credit Balancing funds of the Appalachian Federal Order 1005 and the Southeast Federal Order 1007 should be consolidated into a newly established Transportation Credit Balancing fund for the proposed consolidated Southeast Federal Order. This procedure will enable the transportation credits to continue without interruption under the proposed consolidated Southeast Federal Order.

D. The Marketing Area Should Be Expanded in Virginia.

Proposal 3, proposed by the Southern Marketing Agency, Inc.; and Proposal 4, proposed by the Kroger Company, both address the need to expand the marketing area to additional counties in the Commonwealth of Virginia. Proposal 3 should be adopted and Proposal 4 will then be redundant and unnecessary.

Southern Marketing Agency, Inc. submitted the additional proposal No. 3 for consideration at this hearing to consolidate the current Appalachian and Southeast Federal Milk Marketing Orders. It would add a number of counties and other areas of local government in Virginia to the marketing area of the Southeastern United States Order.⁷

This proposal will have the effect of "locking in", as fully regulated plants under the proposed

⁷ The proposal would add in §1007.2 the following counties and cities to those already listed in Proposal No. 1 under the subheading "Virginia Counties and Cities": In "Counties" add Alleghany, Amherst, Augusta, Bath, Bedford, Bland, Botetourt, Campbell, Carroll, Craig, Floyd, Franklin, Giles, Grayson, Henry, Highland, Montgomery, Patrick, Pittsylvania, Pulaski, Roanoke, Rockbridge, Rockingham, Smyth, and Wythe, and In "Cities" add Bedford, Buena Vista, Clifton Forge, Covington, Danville, Galax, Harrisonburg, Lexington, Lynchburg, Martinsville, Radford, Roanoke, Salem, Staunton. Exhibit 48 Item 38 -and Exhibit 48 Item 39 -are maps depicting the proposed additional marketing area and the location of plants within the proposed additional area.

Southeast Federal Milk Marketing Order, the fluid milk distributing plants which are current Appalachian Order plants located at Lynchburg, Virginia, the Westover Dairy - Kroger Company plant, and the Roanoke, Virginia, Valley Rich Dairy - National Dairy Holdings plant. Both the Lynchburg and Roanoke plants have been pool distributing plants under the Appalachian Order since the order's inception in January 2000. Lynchburg and Roanoke are in the southern portion of the State of Virginia, very close in proximity to the current Appalachian marketing area.

The inclusion of the southern Virginia counties contiguous to the Appalachian Order would solidify and perpetuate the regulation of the Lynchburg and Roanoke plants in the proposed Southeast Order. Further, the inclusion of additional marketing area northward up the Shenandoah Valley is expected to regulate, as a pool distributing plant in the proposed Southeast Order, the plant located at Mt. Crawford, Virginia. This plant is owned and operated by Dean Foods Co. - Mt. Crawford Division - Morningstar Foods.

The Mt. Crawford plant is currently a fully regulated distributing plant under the Northeast Federal Milk Marketing Order, but since the Northeast Order's inception in January 2000 has alternated between partially regulated and fully regulated status. During the month of October 2003, 79 producer-members of Dairy Farmers of America, Inc.; 14 producer-members of Land-O-Lakes, Inc.; and 6 producer-members of Maryland & Virginia Milk Producers Cooperative Association, Inc. delivered milk to the Mt. Crawford plant.

To the best of our knowledge and belief, the regulatory status of no other plant would be impacted by the inclusion of the proposed additional Virginia counties and cities.

In support of Proposal 3 regarding expansion of the proposed "Southeast" marketing area in Virginia, proponent cooperatives make the following points:

1. The regulation of the Lynchburg and Roanoke plants should be continued in the proposed Southeast Order without regard to the location of Class I route disposition from those plants. The addition of marketing area in the southern Virginia counties nearby and adjacent to the current Appalachian Order marketing area will perpetuate the regulation of these two plants as current, i.e. regulated in the "southern" order(s), as opposed to possible regulation in some other Federal Order. The Lynchburg and Roanoke plants compete for a milk supply with plants located further south, that is North and South Carolina plants, and to insure an adequate supply for the Lynchburg and Roanoke plants the producers delivering to those plants must receive a blend price not less than that generated by the proposed Southeast Order.

It is our understanding from the operator of the plant that some possibility exists for the Lynchburg plant to distribute a plurality of its Class I route distribution in the Order 1 area, thus becoming a fully regulated distributing plant under that Order. Significant economic harm could come to the producers delivering to the Lynchburg plant if such were to occur. Additionally, the Lynchburg plant would be significantly disadvantaged in its procurement of milk if the blend price returned to producers delivering to that plant were an Order 1 blend price, when that plant is in direct competition for producer milk supplies with plants regulated in the proposed Southeast Order. In order to maintain its raw milk supply the Lynchburg plant would be forced to pay additional over-order prices not less than the difference between the Order 1 blend price and proposed Southeast Order 7 blend prices, resulting in unequal and uncompetitive Class I pricing to the Lynchburg plant. The Southern Marketing Agency, Inc. additional proposal seeks to preserve the regulatory status of the Lynchburg and Roanoke plants and avoid a disruptive and disorderly condition of blend price and regulatory differences.

2. In order for the Mt. Crawford, Virginia plant to procure an adequate supply of milk, producers delivering to that plant must receive a blend price equivalent to the blend price generated under a "southern" order. The milk supply located near the Mt. Crawford, Virginia plant is an attractive source of supply for plants located in southern Virginia which are currently fully regulated on the Appalachian Order, as well as plants located in North and South Carolina, and eastern Tennessee. In order to maintain its raw supply the Mt. Crawford plant must pay additional over-order prices not less than the difference between the Order 1 blend price and current Order 5 blend prices, resulting in unequal Class I prices to the plant versus plants nearby, without regard to whether those plants are regulated under the Appalachian or Northeast Orders.

3. The Mt. Crawford, Virginia plant has alternated between fully regulated and partially regulated status under the Northeast Order since the Order began in January 2000. In the 48 months since the Northeast Order was promulgated, the Mt. Crawford plant has been fully regulated 30 months and partially regulated 18 months, a ratio of 60/40 pool status to partially regulated status. During 2002 the Mt. Crawford plant was fully regulated during the months of January, February, June, July, November and December, and partially regulated the other months. The seemingly random change in regulatory status of the plant causes blend price disruptions to the producers delivering to the plant, as well as Class I pricing issues on the plant's route disposition outside of Federally regulated areas when the plant does not qualify as a fully regulated plant. A plant constantly switching into and out of fully regulated status is disorderly on its face, and in the case of the Northeast Order, this condition is exacerbated by that Order's Dairy Farmers for Other Markets provision.

Significant and substantial financial harm can come to producers supplying a plant that alternates between fully regulated and partially regulated status under the Northeast Order because producers may fail to qualify for pooling depending on the month or months during which the plant is regulated or partially regulated. Producers delivering to the plant would be harmed through no fault of their own. The location of the Mt. Crawford plant outside the Northeast Order marketing area makes the possibility of continued regulatory changes very real. Regulating the Mt. Crawford plant permanently under the proposed Southeast Order by including the plant in the proposed Order's marketing area would eliminate this market disruption and insure the fair and equitable treatment of the producers delivering to the plant regardless of changes in the location of Class I route disposition from the plant.

4. Regulating the Mt. Crawford plant in the proposed Southeast Order would offer cooperative suppliers to the plant the opportunity to maximize logistical efficiencies in supplying the plant, as well as the broader Southeast market. Mt. Crawford, Virginia is located on Interstate 81, a major north-south artery to the Southeast for out-of-area supplies from the middle Atlantic area. In the short supply months, milk from the middle Atlantic area is drawn south to supply the critically milk deficit fluid milk market currently covered by the Appalachian and Southeast Orders. Conversely, as milk is seasonally surplus in the southeast, milk is sent back north to the surplus manufacturing plants in the middle Atlantic area. Local milk and out-of-market milk are "domino-ed", rolling in and out as seasonal shortages and surpluses come and go. The Mt. Crawford plant is strategically located to serve as the first "domino-able" plant in the chain of milk supply for the southeast. Domino-ing milk as seasonal supply and demand changes is the most efficient and cost effective system for balancing a fluid milk market. The regulation of the

Mt. Crawford plant as a part-time Order 1 plant, coupled with the Order 1 Dairy Farmers for Other Markets provision makes such logistical efficiencies unattainable. Regulation of the Mt. Crawford plant permanently by the proposed Southeast Order would allow the cooperative suppliers of the plant to take advantage of logistical and operational efficiencies in supplying both the Mt. Crawford plant, as well as the larger market.

5. The Lynchburg, Mt. Crawford, and Roanoke, Virginia plants are all currently fully regulated under a Federal Milk Marketing Order. The Southern Marketing Agency, Inc. additional proposal would perpetuate the regulation of the two Appalachian Order plants in the proposed Southeast Order, and fix the regulation of the Mt. Crawford plant as a fully regulated plant under the proposed Southeast Order. As such, the impact of the Southern Marketing Agency, Inc. additional proposal on the Virginia State Milk Commission and Virginia base-holder producers would be insignificant. If there were to be any impact on Virginia-base holder producers the impact should be positive, reflecting the likely higher regulated average blend price at the Mt. Crawford plant under the proposed Southeast Order versus the Northeast Order.

6. The current Appalachian Order, and the new Southeast Order as proposed by Southern Marketing Agency, Inc., regulates a cooperative-operated supply plant located in the State of Virginia as if the plant were located in the marketing area. The typical Federal Order provision regarding cooperative supply plants requires location within the marketing area. Since the promulgation of the Carolina Federal Order, a predecessor Order to the current Appalachian Order, the Secretary has recognized Virginia, and the milk supply located therein to be integral to the supply of milk and marketing of milk in the Southeast. The Southern Marketing Agency, Inc. additional proposal regarding the pooling of three fluid milk distributing plants located in the

State of Virginia simply extends the Secretary's previous recognition of Virginia and its milk marketing association with the south from cooperative-operated supply plants to fluid milk distributing plants.

In summary, based on the record clearly established, the proponent cooperatives urge the Secretary to expand the proposed Southeast Federal Order No. 1007 as proposed in Southern Marketing Agency, Inc. Proposal No. 3. We believe that the record clearly demonstrates the need for this further action.

Proponent cooperatives are not opposed to the adoption of Proposal No. 4. However, we believe that the purpose for the adoption of proposal no. 4 would be achieved by the adoption of the Southern Marketing Agency, Inc. Proposal No. 3 and therefore the adoption of Proposal No. 4 would be redundant and unnecessary.

E. Dual Pooling Should Be Prohibited; Proposal 6 Should Be Adopted.

Proposal 6 in the hearing notice should be adopted to prohibit the simultaneous pooling on a state milk order pool with marketwide pooling and on Federal Order VII in the Southeastern United States. The prohibition of dual pooling has been accomplished in a number of other federal orders around the country prior to this time. It is a practice which has received universal recognition as disorderly and necessitating regulatory prohibition. For all the reasons that the prohibition has been adopted in other orders around the country and the prohibition should be adopted in the Southeastern United States.

In adopting this prohibition the Secretary should be clear, as was the case in Order 1, that the prohibition does not intend in any way to interfere with or change the ability of state regulatory agencies and producers to participate in over order pools operated by state authorities

such as those presently existing in the Commonwealth of Virginia and the Commonwealth of Pennsylvania. Testimony at the hearing explained the operation of the Commonwealth of Virginia program and its non-interference with the federal order program. This pooling of over federal order values is not something that interferes in any way with the federal order pooling or creates disorder of any sort. The prohibition of dual pooling in federal and state orders should not apply to regulatory programs such as that in Virginia or Pennsylvania and the decision on this issue should make that clear.

F. Proposal 5 of Dean Foods Company and Prairie Farms Dairy to Create a New Mississippi Valley Order Should be Rejected.

It is the view of SMA that all of the evidence which supports the proposed merger of Orders 5 and 7 supports and, indeed requires, the rejection of Proposal 5 to carve out of the region a new Mississippi Valley Order. In addition, we would make the following additional comments and observations:

1. Larger orders v. smaller orders. It appears that Dean Foods advocates multiple, smaller federal orders as a matter of policy. From the very narrow perspective of the Class I handler this could be understandable. After all, the ideal procurement scenario for a distributing plant is an individual handler pool where it distributes its Class I values to its current suppliers only. However, the federal order system has long since rejected that paradigm and in the southeast the era of multiple small orders with differing utilizations is, hopefully, permanently behind us. Thus, smaller pools would, relatively speaking, shift more market power back to the Class I plants in the orders. But those orders would not provide a sufficient regulatory base for an orderly supply to a region which is chronically deficit in milk supply and getting more so. A

larger order is needed to rationalize and streamline supply to the Southeast. More, smaller orders will only complicate and destabilize that regional system; and will not add any real incentives to move milk where it is needed.⁸

2. Inefficiency and disorder would be compounded and additional administration would be required. Another order in the Southeast will complicate and make less efficient milk marketing in the region. The currently disorderly issues with producer qualification differences and blend price discrepancies would be compounded. These issues were described in some detail by Mr. Hollon. (Tr. 943–956) In addition, regional suppliers would have another set of reports and pooling requirements to document and track. The lack of support for the Dean Foods/Prairie Farms proposal underscores its lack of attractiveness to industry participants.

3. The St. Louis plant issues. It is apparent that the concerns of both Dean Foods and Prairie Farms for attracting milk to their Order 32 distributing plants in the St. Louis area are driving Proposal 5 (which was submitted with a not-noticed companion request to split off an upper Mississippi area including St. Louis from orders 32 and 30 for another order). That concern should not distract the Secretary from taking the appropriate action with respect to Orders 5 and 7. There is no showing of a substantial⁹ overlap in procurement for the St. Louis plants and Orders 5 and 7; nor is there any evidence of substantial overlap of sales between those

⁸ In this regard, Elvin Hollon's testimony and detailed analysis of incentives, costs, and effects of a new order (Tr. 933–948; Exh. 67) must be contrasted with Paul Christ's theoretical discussion of the effect of blend price differences. The real-world marketers do not find any real incentive and the theoretical doesn't address the practical issues of producer qualification and the like.

⁹ By "substantial" in this context we mean of an order which would lead to melding the procurement area into one marketing area. There are of course areas of interaction of these adjoining milksheds.

distributing plants and Order 5 and 7 plants. Simply put, the St. Louis issues¹⁰ should not drive resolution of the marketing issues in the Southeast.

¹⁰ Counsel for Sarah Farms has attempted to depict SMA's view as inconsistent or contradictory in regard to how St. Louis should be viewed versus how Order 131 data should be viewed. (See Tr. 967–969) There is no inconsistency. Our position is that the St. Louis (Order 32) problem should not be addressed by changes in the southeast orders 5 and 7. Unlike Proposal 5, Proposal 7 does not attempt to fix Order 131 with changes in Orders 5 and 7. We cite the Order 131 Sarah Farms scenario as an example of what could happen in the southeast if Proposal 7 is not adopted. Order 131 will be fixed with the proposals in the proceeding with respect to that order.

III. PROPOSAL 7 SHOULD BE ADOPTED TO LIMIT THE SIZE OF EXEMPT PRODUCER-HANDLERS IN THE SOUTHEAST TO 3 MILLION POUNDS OF CLASS I PER MONTH.

A. Producer-handlers in the Federal Order System.

Federal Milk Orders achieve their objectives by doing four things: (a) classifying milk according to how it is used; (b) setting different prices for each class of milk, which is a form of price discrimination; (c) pooling the proceeds from all uses of milk to all producers; (d) verifying the accuracy of reports of milk receipts and utilization; and (e) setting and enforcing uniform minimum class prices among handlers. The critical features of these activities that ensure 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 from business acumen. (Christ, Exh. 64, p. 1-2)

The producer-handler exemption on federal milk orders is a regulation which was born of expediency and not of reason. (Cryan, Tr. 584) The exemption is not required by the AMAA, and Orders 5 and 7 should be reformed so that it is applicable only to entities distributing less than 3 million pounds of fluid milk products (Class I utilization) per month to prevent the onset of disorderly market conditions that have been observed in other Orders in which large producer-handlers are currently operating. This requested action will more than generously allow the original intention of the provision – to exempt small dairies which do not impact the pool in a significant way – to continue while restoring the integrity of the marketwide pool for both producers and handlers.

The importance of this issue to the federal order system cannot be overstated. If unlimited scale producer-handlers are authorized they will inevitably spring up to capture the production economies of scale and the benefit of pool exemption. The time to avoid this in the Southeast is now – before the problem arises.

The producer-handler exemption is, as no party disputes, a deviation from the basic federal order principles of uniform minimum prices for producers and uniform minimum class prices for handlers. Orderly marketing in federal milk order markets can only be maintained if any exceptions granted to uniformity are limited and justified so that overall orderly marketing throughout the market orders is preserved. The testimony of Carl Herbein in this record establishes that orderly marketing conditions in the marketwide pools in Orders 124 and 131 have been compromised by large producer-handlers and that such conditions will arise in Orders 5 and 7 if the Department does not take protective action. Herbein's testimony shows that large producer-handlers in Orders 124 and 131 have captured a significant share of the Class I sales, reducing returns to all producers while retaining substantial Class I proceeds for each producer-handler on an individual handler "pool" basis. In Order 124 the three largest producer-handlers, which average nearly 5 million pounds of Class I sales each per month, are larger in size than more than one-third of the fully regulated distributing plants. Two regulated handlers in Order 124 which recently ceased operations attribute their demise in part to the competition from producer-handlers(s) who were not subject to federal order minimum class prices. In Order 131, Sarah Farms has captured more than 15 million pounds of Class I sales per month with prices to large customers which cannot be matched by fully regulated handlers paying Class prices for

their milk. The degradation of the Order 131 uniform price has cost pool producers millions of dollars.

The producer-handler exemption in both Orders 5 and 7 should be reformed to limit it to entities with less than 3 million pounds of Class I sales per month. The record demonstrates that producer-handlers which are smaller than 3 million pounds per month have higher per unit operating costs at the plant level and, therefore, are not capable of major disruptions in the Class I market place. Any producer-handler with volumes up to 3 million pounds per month is generally not likely to be a disruptive competitive force in either Order 5 or 7, barring significant changes in market conditions, technology or other unforeseen circumstances. Consequently, so long as producer-handlers of this size meet the operational requirements of the Order their exempt status should remain.

B. The Authority to Regulate Producer-Handlers under the AMAA is Clear.

The Agricultural Marketing Agreement Act of 1937, as amended, (the “AMAA”) provides clear and plain authority for the full regulation of producer-handlers in federal milk marketing orders. Indeed, the authority is so direct, and the precedents so firmly established, that arguments to the contrary are legally frivolous.

7 U.S.C. § 608c(5)(c), which provides the authorization for marketwide pooling of classified use values among producers, expressly authorizes pooling producer-handlers, as follows:

In order to accomplish the purposes set forth in paragraphs (A) [uniform handler prices] and (B) [uniform producer prices] of this subsection, providing a method for making adjustments in payments, **as among handlers (including producers who are also handlers)**, to the end that the total sums paid by each handler

shall equal the value of the milk purchased by him at the prices fixed in accordance with paragraph (A) of this subsection.
(Emphasis supplied)

Producer-handlers have challenged this authority on multiple occasions, beginning decades ago. The challenges have been uniformly unsuccessful. In Acme Breweries v. Brannan, 109 F.Supp. 116 (N.D.Cal. 1952), the plaintiff brewery processed its own hops and challenged the authority of the Secretary of Agriculture's hops marketing order to regulate the terms of its use of its own-grown hops. The court rebuffed the challenge, pointing out that as a processor Acme was part of the stream of commerce in agricultural commodities which the AMAA was intended to regulate. It was not being regulated in its capacity as a producer, but as a processor, and that was fully authorized by Congress.

In Ideal Farms v. Benson, 288 F.2d 608 (3rd Cir. 1961), the producer-handlers in the New York – New Jersey market launched an all out legal attack on tightened regulations under Order 2 which held them accountable under the Order for milk produced on their own farms, contending then that they do not “purchase” their own milk and, therefore, there is no authority to regulate those transactions. The court disagreed, pointing out:

Were we to accept appellants' construction of the word “purchased” they would avoid the intent of the Act to achieve a fair division of the more profitable fluid milk market among all producers and they would avoid the necessity of sharing the burden of surplus milk. 288 F.2d at 213.

The Act is the same today as it was in 1961, and the attempts to avoid sharing the benefits and burdens of the milk marketplace are also the same today. The legal conclusion must be the same as well.

In addition to the undisturbed court precedents, the Judicial Officer of the Department has also clearly and in great detail explained the Secretary's authority to fully regulate producer-handlers in a series of decisions including In re Independent Milk Producer-Distributors' Association, 20 Agric. Dec. 1 (1961); In re Jacob Tanis, 17 Agric. Dec. 1091 (1958); In re Sunflower Dairy, 15 Agric. Dec. 1 (1956).

The Secretary's authority to adopt Proposal 7 to properly regulate any current or future producer-handlers in Orders 5 and 7 is unquestionable.

C. The Secretary Is Empowered by the AMAA to Maintain Stable Markets and Prevent Potential Threats to Orderly Marketing.

Proponents' testimony clearly states that Proposal 8 is preventive, intended to thwart disorderly markets in Order 5 and 7 before the fact. (Hollon, Tr. 643, 650) Cross examination by opponents' counsel implied that the Secretary is not authorized to act absent a showing of existing disorder. (T. 643)¹¹

The producer-handlers' counsel disclose a basic misconception of what the hearing record must show to warrant exercise of the Secretary's regulatory powers. Section 608c(3) of the AMAA provides:

Whenever the Secretary...has reason to believe that the issuance of an order [amendment] will tend to effectuate the declared policy of [the Act]...he shall give notice and opportunity for a hearing upon a proposed [amendment].

¹¹ Counsel for Sarah Farms stated that if the parties agreed that there is no disorderly marketing in Orders 5 and 7 at present, he would "make a motion at this point that without a (sic) disorderly marketing that we cannot make any kind of change to [Order 5 or 7] in the limitation [proponents] are talking about" referring to Proposal 7.

The issuance of a notice of hearing on Proposal 7 constitutes a two-fold determination by the Secretary that (1) the Proposal is one that lawfully may be adopted, (2) there is “reason to believe” it may promote the AMAA’s “declared policy.” That policy declaration appears in Section 2(1) of the AMAA. It provides that the Secretary should exercise the regulatory powers conferred by the Act “to establish and *maintain*...orderly marketing conditions.” (Emphasis added.)

There is nothing in the AMAA that requires the Secretary to wait before exercising her regulatory powers until chaotic or disorderly marketing conditions are shown to exist in the Order 5 and 7 marketing areas. In In re Independent Milk Producer-Distributors, 20 A.D. 1, 24-25 (1961) the Secretary’s Judicial Officer explained:

The Secretary can regulate to cope with potential threats to a then-existing orderly market. The Secretary need not stand powerless or shut his eyes to possible disruptive factors or eventualities in a regulated market.

...

[P]etitioners attack some of the testimony advanced at the...amendment hearing because such evidence does not demonstrate present disorderly marketing conditions which affect order minimum prices to producers. As indicated above, potential threats to order objectives may form a basis for regulation and evidence indicating such possibility is sufficient to support regulation to maintain orderly conditions. (Underline in original.)

In the recent Tentative Decision on Proposed Amendments to Order 135, 68 Fed.Reg. 49375 (August 18, 2003) the Secretary deleted from the Order the proprietary bulk tank handler provision which, as the Secretary found, caused “disorderly marketing conditions because the order is unable to establish minimum prices that are uniform among regulated handlers, a

requirement of Section 608c(5) of the AMAA.” (68 F.R. at 49383). The record evidence here is clear beyond dispute that the exemption of producer-handlers from the minimum pricing provisions of Order 5 and 7 ultimately threatens not only orderly marketing, but a breakdown of the order system unless subject to the limits of Proposal 7.

D. Evidence in Support of the 3,000,000 Pound Cap.

1. The record supports adoption of Proposal 7.

The issue of larger 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 offered by proponents 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. These problems 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. The issue has led to discussions in some portions of the United States dairy marketplace to lower regulated prices in order to provide some competitive equity. (Hollon, Exh. 47)

Large unregulated producer-handlers cause market disorder in numerous ways. Such producer-handlers draw sizable dollars out of the Order 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. They have serious competitive impact on handler equity causing a loss of sales, thus robbing the pool of Class I dollars. High volume producer-handlers have the ability to service multiple retail accounts, thus impacting competitive pricing in the market. They have

balancing costs that are a small percentage of the advantage offered by avoiding class prices. Large producer-handlers are larger than many of the regulated handlers in Federal Order system and are a statistical anomaly in terms of size in the Federal Order system. The proposed limitations will have no impact on the current operational ability of nearly all of the producer-handlers in the Federal Order system. Large unregulated producer-handlers 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 for other regulated handlers. (Hollon, Exh. 47, p. 2-3).

Proponents' expert witnesses demonstrated that significant economies of scale are realized by handlers at the 3,000,000 pound level and allowing producer-handlers of that size and larger to exploit the producer-handler exemption results in disorderly market conditions.¹² (Hollon, Tr. 676-679)

An unregulated high volume producer-handler has a price advantage within any order equal to the Class I price less the blend price. (Cryan, Tr. 590) This difference, given the keen price competition in the dairy industry, is always significant. (Hollon, Tr. 659) Hollon testified as follows:

At this point I would like to insert two comments. One is that Mr. Herbein and Mr. Lee pointed out that in their experience, both from accounting with various businesses; and Mr. Lee from his experience in his day to day activities [as a procurement manager for Prairie Farms], that a range of less than a cent per gallon was a significant number.

¹² After considerable colloquy between Judge Palmer and counsel for Sarah Farms, the Judge directed that the testimony of Mr. Herbein be admitted to the record of this hearing including all testimony and all exhibits from the Order 124 and 131 record as Exhibit 57 in this proceeding. (Tr. 463-464)

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 market place 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 stay competitive themselves. Usually the lowest price puts pressure on every other price. (Hollon, Tr. 659-660)

In two paragraphs, Hollon has described disorderly marketing as it presently exists in Order 124 and Order 131. Such conditions will inevitably develop in Orders 5 and 7 if the Secretary fails to take preemptive action pursuant to the power granted in the AMAA.

There are a number of compelling reasons why three million pounds is an appropriate level at which to “cap” the producer-handler exemption: (1) It is the level applicable in the Fluid Milk Promotion Act of 1990, 7 U.S.C. 6401– 6417, and, therefore, it embodies a determination by Congress that fluid milk handlers at that level are important participants in the Class I marketplace nationally. (2) Data with respect to volumes of sales from stores indicates that at the 3 million pound per month level, a handler could supply sufficient stores in a metropolitan area to be a substantial factor in the retail market place. (3) At a level of 3 million pounds production, handler plant economies of scale are sufficient that the handler side of a producer-handler can be competitive with fully regulated handlers. The smallest producer-handlers have unit processing costs disadvantages which are sufficient to offset the advantage gained from being exempt from pooling. However, those dis-economies of scale are overcome at or about the 3 million pound per

month level as Herbein's data and various academic studies indicate. (4) A three million pound per month producer has substantial economies of scale on the production side which give him a cost advantage on the producer side which, if the producer-handler is exempt from pooling, can be used as a competitive weapon in the fluid milk sales marketplace. (Hollon, Exh. 47, p. 18) The record clearly establishes that producer-handlers with Class I sales above 3 million pounds should not be exempt from pricing and pooling in any of the Federal Orders, including in Orders 5 and 7.

2. Admissibility of the Herbein study and related evidence.

Carl Herbein's testimony has been attacked in this hearing and in the Order 124 and 131 proceeding by Sarah Farms and its counsel, along with the other opponents. In the Order 124 and 131 rulemaking, Sarah Farms and its fellow opponents have filed a "Motion To Strike Testimony and Exhibits Concerning Plant Costs as Testified to by Carl Herbein, CPA" (Motion to Strike). In their Motion to Strike, the opponents have done a workmanlike job of creating a straw man and then setting about to destroy it. Proponents fully expect that the same motion will be filed in this rulemaking by counsel to Sarah Farms and the four exempt producer-handlers in Order 124, all of which counsel are participating in this rulemaking and, indeed, the Motion was made orally at the hearing. (Tr. 546)

The basis for the argument against the evidence presented by SMA and other proponents of the 3,000,000 producer-handler cap is that Herbein's testimony would not be admissible applying precedents which use the Federal Rules of Evidence and the Federal Rules of Civil Procedure for proceedings in a United States District Court. The opponents then wage a robust attack, in a 20 page document, on the Herbein study based on the requirements for expert testimony citing Daubert v. Merrell Dow Pharmaceutical, Inc., 509 U.S. (1993). This is a straw

man because the standards for admissibility of expert testimony in USDA rulemaking proceedings are not the Federal Rules of Evidence and Civil Procedure. The applicable standards of evidence in this proceeding before the Department under the AMAA are contained in 7 C.F.R. Section 900.8 which provides in relevant part:

(2)(d) Evidence—(1) In general. The hearing shall be publicly conducted, and the testimony given at the hearing shall be reported verbatim.

(i) Every witness shall, before proceeding to testify, be sworn or make affirmation. Cross-examination shall be permitted to the extent required for a full and true disclosure of the facts.

(ii) When necessary, in order to prevent undue prolongation of the hearing, the judge may limit the number of times any witness may testify to the same matter or the amount of corroborative or cumulative evidence.

(iii) The judge shall, insofar as practicable, exclude evidence which is immaterial, irrelevant, or unduly repetitious, or which is not of the sort upon which responsible persons are accustomed to rely.

(4) Exhibits. All written statements, charts, tabulations, or similar data offered in evidence at the hearing shall, after indication by the proponent, and upon satisfactory showing of the authenticity, relevancy, and materiality of the contents thereof, be numbered as exhibits and received in the evidence and made a part of the record. *** If the testimony of a witness refers to a statute, or to a report or document (including the record of any previous hearing) the judge after inquiry relating to the identification of such statute, report, or document, shall determine whether the same shall be produced at the hearing and physically be made a part of the evidence as an exhibit, or whether it shall be incorporated into the evidence by reference. If relevant and material matter offered in evidence is embraced in a report or document (including the record of any previous hearing) containing immaterial or irrelevant matter, such immaterial or irrelevant matter shall be excluded and shall be

segregated insofar as practicable, subject to the direction of the presiding officer.

Herbein's testimony establishes, inter alia, that economies of scale are realized by producer-handlers as their size increases. Producer-handler costs are at the very heart of this rulemaking as in the rulemaking for Orders 124 and 131. There is no doubt whatsoever that such evidence is material, relevant, and of the sort upon which responsible persons are accustomed to rely. Indeed, opponents do not even argue to the contrary. It is apparent that Herbein's study and oral testimony were correctly admitted in this rulemaking just as in the Order 124 and 131 proceeding.

Consistent with the applicable rules of evidence in this hearing, Mr. Herbein was qualified and acknowledged by Judge Victor W. Palmer as an expert witness over the objection of counsel to Sarah Farms. (Tr. 444) Moreover, the motion to strike Herbein's testimony in this hearing made by counsel to the Order 124 producer-handler opponents was summarily denied by Judge Palmer. (Tr. 546)

The Motion to strike Herbein's testimony in the Order 124 and 131 rulemaking, emphasizing that opponent's counsel do not have the opportunity to personally review Herbein's files, is well wide of its mark. The data Herbein used in his study, as was thoroughly explained and testified to before the ALJ, is from the proprietary data base of financial information of clients of the accounting firm of Herbein and Company. Under the rules governing accountant client confidentiality, Herbein can not disclose such information from his firm's confidential data base. Moreover, Herbein and Company is under a contractual duty to its clients whose data was used in the study not reveal the identity of those clients. Opponents and their counsel surely understand

and appreciate this requirement of professional responsibility, yet in their Motion to Strike they refer to “an *allegedly* confidential database” maintained by the accounting firm of Herbein and Company. (Motion to Strike, p. 2) (Emphasis added) This assertion is made when there is no evidence in the record which would challenge in any way the contractual obligation of confidentiality between Herbein and Company and its clients.

Opponents argue that the confidentiality requirements incumbent upon Herbein and Company should be disregarded and that opponents should be given access to the confidential information of Herbein’s clients. Opponents claim that Herbein could produce such confidential data “without disclosing the specific plants from which the costs came” and that “[t]his information could be provided without naming the plants or otherwise identifying the sources.” (Motion to Strike, p. 10). The insincerity of this contention is patent inasmuch as no verification of the underlying financial data would be possible without opponents knowing the names of the companies and the specific plants involved, seeing tax returns, books of account, production records, and perhaps other records of the subject firms¹³. In other words, instead of relying upon Herbein, they would be stuck with relying upon the business records of parties not known and not testifying. And the contention “How can we trust that when we can’t examine the preparer?” would just be moved to another target.

Producer-handler opponents simply are not willing to engage in debate with the proponents of Proposal 7 on the same evidentiary level: They complain about what they are not able to do under the Rules of Practice here, but do not do what they are able to. By way of

¹³ Of course, no client companies are likely to consent to disclose such information in this type of proceeding which has no procedures for protective orders and the like which are common in Federal courts.

complete, total, absolute and stark contrast to proponents who put forward all evidence they could assemble (without compulsory process which is not available), none of the opponents in the Order 124 and 131 rulemaking, notwithstanding that they were actual parties to the proceedings, would reveal the least bit of financial information about their own businesses to support their repeated claim that they experience high balancing costs and somehow have special operational risks. Undoubtedly opponents would have been more than delighted to have completely one-sided discovery in the Order 124 and 131 rulemaking, or here, but of course no such thing is required or permitted under the Rules of Practice before the Department. However, if opponents were willing, as parties to the rulemaking proceedings, to make such information available in accordance with the terms of the Federal Rules of Evidence and Federal Rules of Civil Procedure including, of course, full document discovery and compelled testimony of witnesses under oath, the great myths on which they have predicated their arguments, that high volume producer-handlers are burdened with high balancing costs and extraordinary operational risks, would be dispelled, debunked and disposed of once and for all.

3. The opponents' unsupported assertions and failure to produce any evidence reinforce the strength of proponents' case.

In evaluating the record of this rule making, the Department's action must be based on substantial evidence contained in the record considered as a whole. In ascertaining the presence or absence of substantial evidence, the agency "is obliged to search the entire record, or those parts to which the parties refer [it], to determine whether on the basis of all the testimony and exhibits before the agency it could fairly and reasonably find the facts [it acts upon]." Braniff Airways, Inc. v. C.A.B., 379 F.2d 453, 462 (D.C. Cir 1967). See generally, Universal Camera

Corp v. N.L.R.B., 340 U.S. 474, 488 (1951). Substantial evidence requires that all evidence be weighed on its own behalf and “in light of contrary evidence that may also appear” in the record. Braniff Airways, Inc. v. C.A.B., supra, 379 F.2d at 463

Considering the record as a whole means consideration of what has not been produced as well as what has been brought forward. When a party to an administrative proceeding “has relevant evidence within his control which he fails to produce, that failure gives rise to an inference that the evidence is unfavorable to him.” International Union (UAW) v. N.L.R.B., 459 F.2d 1329, 1336 (1972). Furthermore, any failure to produce evidence “not only strengthens the probative force of its absence, but of itself is clothed with a certain probative force.” International Union, supra, 459 F.2d at 1336.

In this hearing and generally within the industry, opponents have made various implicit and explicit assertions that the exemption is justified because producer-handlers have high balancing costs and extraordinary business risk which allegedly offset the clear and certain benefit of exemption from minimum class prices. (Tr. 478-489, Tr. 525) However, opponents have not produced any evidence to support such claims and insinuations, but instead have merely tried to denigrate the proponents’ evidence. The Secretary must evaluate this record both in light of what has been said, and what has been deliberately left unstated.

The opponents’ case against regulation of large producer-handlers here is without substantiation. The opponents initially attacked proponents’ expert testimony on the basis that the witnesses relied on economic data and analysis from sources other than producers and handlers located in Order 5 and Order 7. (Tr. 477) The claim was implicitly made that the proponents’

economic data and analysis, therefore, cannot possibly be applicable to producer-handler activity in these two Orders. (Tr. 481) Opponents' arguments lack merit.

Opponents do not offer a shred of evidence to support the notion that they face inordinately high balancing costs and high operational risk-related costs. Of course, in the event that an exempt producer-handler had an imbalance in its supply of raw milk, it could buy or sell milk from pooled producers or regulated handlers as needed, but it would become pooled. *In other words, the high balancing costs and high operational risk on which opponents base their claim to exemption add up to nothing more than the fact that in a given month when a producer-handler has an imbalance in its supply of raw milk it may have to participate in the pool, the very thing that all the regulated handlers and pooled producers within each order do all the time as a matter of course.*¹⁴

The exempt producer-handler participating in this hearing, Sarah Farms, which is located in Order 131, obviously prefers that the regulations remain unchanged to protect its advantages, rather than be treated like all the other producers and handlers in any Federal Milk Marketing Order and competing on a level playing field. The position adopted by the exempt producer-handlers is as understandable from their perspective as it is grossly unfair and disruptive to the rest of the market players, the pool producers and regulated handlers.

¹⁴ When this "risk" is analyzed a bit more, it may be clear why it hasn't been quantified by opponents. Becoming pooled because of the need to purchase surplus supplies would at worst lead to the loss of 1/12 of the annual benefit of the producer-handler exemption. This might reduce the advantage from \$1.50 per cwt to \$1.35. On the other side of the equation, the pool (blend price) is a safety net which is always available to the producer-handlers if they have extraordinary losses of Class I sales and, thus, low utilization. Of course, there is no evidence of anything of the sort ever occurring.

Opponents' tactic of asserting that they are rightfully exempt from regulation based on factual claims – that they face high balancing costs and are exposed to inordinate operational risks -- for which no evidence is produced must be evaluated on the basis of a fundamental rule of evidence: A finder of fact may draw an adverse inference when a factual claim made with respect to a person or party asserting a factual claim that has within its control evidence that is probative of such claim, either in the affirmative or the negative, and refuses to produce such evidence. See 2 J. Wigmore, Evidence § 285 (Chadbourn Rev. 1979). The “adverse inference” rule is a venerable rule of evidence which “is based on the belief that a party will introduce all relevant evidence which is favorable to him on his own initiative.” International Union (UAW) v. NLRB, 459 F.2d. 1329, 1345 (D.C. Cir 1972) (emphasis in original). The rule, which traces its origins as far back as 1722 (see 2 J. Wigmore, Evidence § 285 (Chadbourn Rev. 1979)), is nevertheless, “more a product of common sense than of the common law.” International Union, 459 F.2d at 1335.

The rule specifically impacts the evaluation of “substantial evidence” in a hearing record for purposes of agency action pursuant to 5 U.S.C. § 706. The facts and circumstances in this proceeding are akin to those in which the courts have held that an adverse inference is applicable. In International Union, the employer testified to innocent reasons for firing union employees, but refused to produce the company's records regarding the actions. The Circuit Court held that an adverse inference was applicable and, therefore, the record would not support a finding that the testimony (without the records) was sufficient to support the employer's case. The same logic should be applied here to weigh the objecting producer-handlers' attacks on proponents'

arguments and evidence while failing to make a full appearance in this rulemaking and failing to produce any evidence in support of their opposition.

Much of Mr. Herbein's testimony in Alexandria (made a part of this record specifically at the request of opponents) was based on Exhibit 68, the pro forma statement of effects of regulating producer-handlers above 3 million pounds in Order 124. Herbein was repeatedly questioned by counsel for the opposing producer-handlers with respect to what he did or did not study and what his numbers do and do not represent, persistently emphasizing the refrain that Mr. Herbein did not know actual participating producer-handler production costs (because those costs are solely within the control of the objecting producer-handlers who did not produce them for the hearing). Because opponents' had within their control the evidence to contradict Herbein's testimony if it was not correct, but did not come forward with that evidence, the Department must accept Herbein's conclusions that large producer-handlers could withstand regulation.

In opposition to the proponents' evidence presented in this hearing, the opposing producer-handlers have simply failed to produce *any evidence whatsoever*. On the basis of this record, the Department must accept proponents' evidence and disregard the unsupported arguments in opposition.

In evaluating this entire record, the Department must draw the appropriate inferences from Sarah Farms and its allies failure to produce the evidence within their control. Those inferences are that if produced the evidence would support the positions of the proponents on the issues of economic impact. Drawing such inferences is compelled by established principles of law applicable to administrative proceedings. This failure to produce data exclusively within their

control should lead the Secretary to apply the adverse interest rule and adopt Proposal 7 given the opponents' total failure to make a case.

E. Operation of Proposals to Reform the Producer-Handler Regulation.

The proposed amendments to the producer-handler language in both Orders 5 and 7 make a single major change to the language provisions, the 3 million pound volume limitation, and a number of lesser, but nevertheless important, language changes. We will discuss the several changes in turn.

1. The three million-pound Class I distribution limit. The most important change in reform of the producer-handler exemption is to limit it in size/volume. The limit is not upon total production at the farm level; it is upon "total route disposition and transfers in the form of packaged fluid milk products" during the month. The limitation is not upon disposition within the marketing area; it is upon total disposition so that a large producer-handler could not evade the size limitation by splitting its volume into two marketing areas, or one federal order area and unregulated areas. This volume limit allows more than 99% of dairy farmers, at their current size, in the federal order system to be exempt producer-handlers if they so choose. It denies that privilege and exemption to the very few largest producers.

2. Sales in conjunction with pool handlers. Producer-handlers in Orders 5 and 7 should be subject to the same limitation which presently applies in Order 131 and prohibits producer-handlers from distributing products in containers and with labels that are the same as regulated handlers. This tactic clearly allows producer-handlers to balance with pool supplies and potentially avoid any surplus disposal of their own. This language should apply chain-wide to all stores using the particular private label.

F. Proposal 8 Should Not Be Adopted.

Proposal 8, which would allow producer-handlers to balance their needs for milk by purchases from the pool, up to 10% during December through May and 30% during June through November, is antithetical to the Secretary's oft-stated basis for the producer-handler exemption:

Generally, under a Federal order it has not been necessary, in order to fully achieve the purposes of the statute, to regulate fully a person who processes in his own plant milk from his own farm production and does not receive milk from other dairy farmers.

24 Fed. Reg. 5372 (1959)(quoted in In re Independent Milk Producer Distributors' Association,

20 Agric. Dec. 1, 5 (1961). Proposal 8, if adopted, would create a producer-handler

Frankenstein: Without any volume limits, an exempt producer-handler could rely upon the pool to balance its needs. This would provide the best of all worlds for the producer-handler:

Exemption on all its own milk production and balancing from the pool without being pooled. It would mean the worst of all worlds for the pool: All the market surplus would be pooled and just enough Class I to balance the exempt producer-handlers. Proposal 8 should not be adopted.

G. Conclusion concerning producer-handler proposals.

The Secretary has the opportunity, and the obligation, in this proceeding to intervene and prevent the origination of disorderly conditions which, if not prevented, will lead to the disintegration of the entire federal order system. The exemption from federal order pooling for producer-handlers must be limited, with a volume maximum, in order that orderly marketing be maintained in Orders 5 and 7. There is no question in the minds of industry members that gargantuan producer-handler operations could spread in these orders, and spring up throughout the system if regulatory limits are not established. The participation in this hearing of parties

from other orders, and parties who are not yet producer-handlers. in support of the current unlimited exemption reinforces the pertinence of these proposals. Indeed, the economic incentive, as demonstrated by Sarah Farms, a party appearing in this proceeding despite the fact that it has no operations in Order 5 or Order 7, is so great that once large producer-handlers enter a market other handlers will be compelled, for their own survival, to follow suit or exit the business. The circumstances are compelling; the need is urgent; and the consequences of failing to act are terminal for federal orders under the AMAA.

Southern Marketing Agency, Inc. respectfully urges the Secretary to adopt Proposal 7 and reject Proposal 8.

IV. CONCLUSION

On the basis of all the evidence in the record, and the discussion in this brief, Southern Marketing Agency, Inc., respectfully requests that the Department:

(1) Adopt Proposals 1, 2, and 3 to merge existing Orders 5 and 7 with the terms requested and extend the marketing area into the additional counties and cities in the Commonwealth of Virginia;

(2) Reject Proposal 4 as unnecessary with the adoption of Proposal 3;

(3) Reject Proposal 5 as inconsistent with the adoption of Proposals 1 and 2;

(4) Adopt Proposal 6 to prohibit dual pooling on merged Order 7;

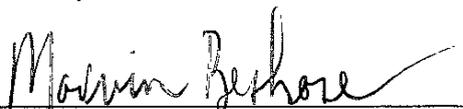
(5) Adopt Proposal 7 to limit the exemption for producer-handlers in the Southeast to less than 3 million pounds of Class I sales per month, while rejecting Proposal 8 which would authorize producer-handlers in the Southeast to balance off the pool; and

(6) Adopt such conforming changes to the orders as may be appropriate pursuant to Proposal 9.

SMA thanks the Department for calling this hearing and allowing our concerns and proposals to be heard.

Respectfully Submitted.

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