Before the Secretary
United States Department of Agriculture

Regarding Milk in the Appalachian and Southeast Marketing Areas
Proposed Amendments to Orders

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

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Hearing Brief

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Land O'Lakes (LOL) is a dairy cooperative with more than 3,500 dairy farmer member-owners. The cooperative has a national membership base, whose members are pooled on six different federal orders For more than 10 years Land O'Lakes has provided a supplemental supply of milk to the Southeastern markets and during that period have had members pooled on the Appalachian and Southeast federal orders.

LOL supports Proposals 1 and 3; opposes Proposals 4 and 5 and takes no position on Proposal 2. As a supplier of supplemental milk to the Southeastern orders, LOL relies on transportation credits to help defer the transportation costs of moving milk from the cooperative's Northeastern and Midwestern milk sheds. Additionally, continuing the current diversion pricing relationship is essential to maintaining a direct-shipped and balanced-supplemental milk supply for the Southeast region.

Land O'Lakes Recommends the Adoption of Proposals 1 and 3

Transportation credits were instituted in the Southeast Orders based on a recognition that the region's Class I demand would have to be satisfied by importing large volumes of milk from dairy farms located outside of the orders' marketing areas. In 1996 a system of transportation credits were installed into the Southeastern orders that were funded by assessments on

Class I sales. Payments are made to handlers on volumes of milk imported into the Southeast for Class I use from July through December.

During the intervening 10 years we find that the total milk produced by farmers located in the Southeast has declined and is no longer sufficient to satisfy in-area Class I demands during any season of the year. (Sims, Day 2, page 118) We also find that the geography required to fulfill the region's supplemental supply has increased to include 28 states. Led by increases in diesel fuel prices, the cost of transportation far exceeds the current $0.035 per hundredweight per 10 miles transportation credit payment. The result of these impacts were that only 46 percent of requested transportation credits were covered by those funds in 2004, while approximately 94 percent of the credits were covered through the Orders' transportation credit funds in 1997. (Exhibit 25, page B)

Land O'Lakes agrees with the testimony presented by Jeffery Sims on behalf of the Southeastern Marketing Agency et al. (SMA) on Proposals 1 and 3. SMA testified persuasively that transportation costs per mile have increased since 1997and the distance between the required supplemental supplies and the marketing areas have also increased. The three-cent increase in assessment rates in November 2005 is grossly insufficient to cover any significant portion of the cost of importing the supplemental needs of the region.

The evidence presented in the Hearing clearly provides a rationale for increasing the transportation credit for supplemental deliveries, based on SMA's proposal and the need for increased Class I assessments consistent with Proposal 3.

Proposal 4 Places an Unrealistic Burden on Supplemental Suppliers

When Transportation Credits were installed into the Southeast orders the Secretary was vigilant in requiring payments would only be made on deliveries of supplemental supplies for Class I use. To this end, the Orders included provisions that excluded payment for the first 85 miles of travel and required that the producer, requesting payment, reside outside of the marketing area and be off-market at least two months of the previous February through May period. Payments are made only on milk allocated to Class I and the payment is reduced by the positive difference between the farm and the receiving plant's Class I zone. Moreover, payments are only made from July through December, when the existing Order provisions for producer status through touch-base deliveries and diversion limitations are already the most stringent.

The proponent for Proposal 4 attempts to place new restrictions on dairy farmers attempting to collect transportation funds for delivering needed Class I milk to the market. The proponents assert the Transportation Credit provisions of Orders 5 and 7 have been abused and they have subsidized the delivery of milk to the Southeast which is not required for the efficient operation the market. They make this claim in spite of the evidence that the transportation credit pools have been under-funded and that the payments in Order 7 have been as low as 23 percent and Order 5 as low as 30 percent during 2005. (Exhibit 8, page 10 and Exhibit 15-A)

They propose a new relationship be established where the denominator is the handler's pooled volumes and the numerator is the volume of pooled milk not delivered to an Federal Order 5 or 7 pool distributing plant. If this ratio exceeds 30 percent, then the handler's transportation credits will be paid pro rata based on the resulting percentage. In explaining the reason for the 30 percent threshold, the proponent naively asserts ". . . that there is typically five strong production days at a distributing plant and seven days in a week. Five as a percent of 7 is 71 percent; the inverse is 29 percent, which was rounded up to an even 30 percent." (Evan Kinser, Day 3, page 63)

The proponent has a Pollyannaish view of milk marketing. For October 2004, he asserts that the reserve supply for the Order 5 market need only be 9.8 percent. He arrives at this figure by multiplying the volume (15,854,686) of the largest distributing plant delivery day (10/28/04) by the days in the month. The result is 491,495,266 pounds. He then compares this number to the actual distributing plant deliveries for the month, 443,223,332 pounds. The difference of the two figures, 48,271,934, is divided by the 491 million and the result is result is 9.8 percent. Hence, from the proponent's view, the efficient operation of the market requires only a 9.8 percent reserve supply. (Kinser, Day 3, page 77-9 and Exhibit 38)

The proponent's example is fraught with unrealistic assumptions. First, he assumes that each handler has equal access to distributing plant deliveries and by implication each handler has the same distributing plant percentage as the market's average. That assumption is not true. Second, the example explicitly compares the highest delivery day to the average delivery day.

(Sims, Day 3, page 245) Comparing the highest delivery day (15,854,686) to the average daily delivery (14,297,527) will yield the same 9.8 percent. The 443 million pound total monthly volume, used in the proponent's example calculation, masks the daily variation. For instance, to satisfy the Class I demands for the highest day (10/28/05) the milk of a fixed group of dairy farmers was required. On the very next every-other-day milk pickup (10/30/06) only 12,748,874 of their pounds was required at distributing plants. That pickup to pickup variation is 20 percent. The same comparison of the highest delivery (10/7/05) and the next pickup day for the Order 7 example requires a 3.5 million pound diversion and a 22 percent reserve supply. Moreover, only in hindsight does one know the day and volume of the greatest distributing demand. SMA's testimony (Exhibit 43) provides a much clearer picture of the day-to-day variations and the reserve supply needed to satisfy the delivery requirements of Class I distribution plants.

Proponents miss the entire concept of the market's supplemental supply and the transportation credit provisions. The Orders require that transportation credit eligible milk lie outside of the marketing area and at least 85 miles from the plant of delivery. Due to the paucity of balancing capacity in the Southeast (Sims, Day 2, page 121), efficient marketers will strive to deliver local milk to the outlets available, which are overwhelmingly distributing plants. Exhibit 16 shows the percentage of milk by state delivered to Order 5 or 7 distributing plants. It's plain that the states lying within the marketing areas of the Southeast orders have a much higher percentage of distributing plant deliveries than out-of-area states. It also follows that milk located outside of the marketing area will have a greater percentage of diversions. Supplemental milk is just that; it is delivered when it is needed by the distributing plants and stays home and is diverted when it is not needed.

The 30 percent ratio of distributing plant deliveries places an unrealistic burden on suppliers of supplemental milk.

Proposal 4 is Defective and Vague

Due to a perceived problem of "pool riding" by "pseudo-handlers," proponents offer the amendments contained in Proposal 4, designed to limit access to transportation credits. For each Order, proponents offer a new relationship for suppliers of supplemental milk to qualify for full transportation credits. For Order 5, a handler's deliveries to plants other than S1005.7 (a) and (b) and S1007.7 (a) and (b) would be compared to total pooled volumes. A ratio greater than 30 percent would result in a prorated transportation credit payment.

While seemingly intending to discourage diversions of Order 5 milk, proponents actually encourage diverted Order 5 milk delivered to Order 7 distributing plants. While Order 5 milk delivered to an Order 7 distributing plant is not eligible for transportation credits, such a delivery could positively influence payment of other imported milk to Order 5 pool plants. Additionally, the proponent would include all milk delivered to 1005.7 (e) unit-pooled plants in the numerator of the ratio, irrespective whether the plant of delivery is the distributing plant or Class II plant of the unit. (Kinser, Day 3, page 163) The effect of this act on the proposed calculation would be to increase the handler's likelihood of prorated transportation credits.

Most confusing is the proponent's treatment of milk transferred from other-order pool plants to Order 5 or 7 distributing plants. The proponent would require the market administrator to review the producer milk deliveries of the handler to determine the extent to which milk transferred from the other-order pool plant is eligible for transportation credits. This becomes complicated when the owner/operator of the plant may have its pooled milk included on another entity's handler report. Moreover, the proposal as written could exclude the operator of a pool supply plant (7c) delivering to distributing plants, exclusively through its supply plant, from getting any transportation credits when that operator delivers its milk only to the pool supply plant and to non-order plants as diversions. In such a case, the handler's 7 (c) deliveries and diversions would only be counted in the relationship's numerator.

Land O'Lakes Requests the Secretary Reject Proposal 4

The Transportation Credits sections of Orders 5 and 7 were instituted to facilitate the delivery of milk into the region for Class I use. Safeguards were instituted during their promulgation to make sure the milk was truly of a supplemental nature. The provisions, as currently written, effectuate the transaction. The proposal is defective and places burdensome restrictions on suppliers of seasonal supplemental milk. Land O'Lakes respectfully requests that Proposal 4 be rejected.

Adoption of Proposal 5 Would Place Onerous Financial Burdens on the Markets' Supplemental Supply

During cross examination, the witness from SMI stated:
1. The Southeast is characterized as a region where the number of dairy farmers and milk production has been steadily decreasing, while population and demand for fluid milk has increased;
2. The Southeast region experiences seasonal variations of milk production;
3. The Orders also experience daily and seasonal demand fluctuations at the markets' distributing plants;
4. The Region's Class III and IV facilities are inadequate to handle the daily and seasonal balancing needs of the market; and
5. The Orders' milk shed has greatly expanded beyond the borders of the marketing area.

From those facts the witness concluded that the market must increasingly find distant volumes of supplemental milk. Moreover, this out-of-area supply must maintain its own reserve processing capabilities at the milk's source. (Sims, Day 2, page 115-24) In answer to another question, Mr. Sims explained that the amount of required reserve supply grows as the distance from the market increases. The logistics of moving milk over great distances requires that adequate volume of reserve milk be pooled. He further explained that a rational allocation of supplies would have the closer milk moved to the distributing plants first, thus causing a larger amount of diverted milk from states distant to the market. (Sims, Day 3 page 11-13 and Exhibit 16-A)

In spite of the fact that the market's natural dynamics has resulted in increasing the distance of the milk shed from the marketing area, Proposal 5 would place onerous financial burdens on the markets' balancers. The effect of proposal would be that some of the distant milk would choose not to be associated with the Southeast orders. While the intent of the Proposal may be to increase producer blend prices in the Southeast, the effect would be limited. Had Proposal 5 been in effect for the twelve months, November, 2004 through October 2005, the average uniform price in both orders would have increased by $0.15 per hundredweight, or 1 percent of the actual average uniform price in each market. The range of effects in Order 7 was from $0.04 in May 2004 to a high of $0.28 in May of 2005, while the Order 5 range was $0.06 in December 2004 and $0.30 in March 2005. (Exhibit 8, page 1 and Exhibit 14-A) However, this limited positive effect to the

Orders' uniform price assumes all the diverted milk continues to be pooled, in spite of the lower prices resulting from Proposal 5.

When evaluating whether to commit a volume for supplemental sales to the Southeast, a handler will add the benefits and costs accrued for the actual milk deliveries to the Southeast with the benefits accrued when diverting to local markets. That aggregate value is compared to the alternative to marketing the milk locally. Proposal 5 will change the calculus; providing a supplemental supply to the Southeast under the proposed regulation will become unattractive for suppliers in the Northeast and Midwest. Only increased over-order payments will keep the supplemental supplies from these regions moving to the Southeast. While the entire market currently bears a large portion of the cost of maintaining a supplemental supply in those regions, the proposed regulation would shift that cost to importing handler. The Land O'Lakes witness opined that supplemental milk from the Northeast and Midwest would change from direct delivered producer milk to bulk milk transfers from other-order plants as an as-available and spot-market priced transaction. An additional unintended result of the Proposal would include the shifting of the Class I benefit from the Southeast Orders' pools to the Order of the out-of-area pool plant. (Schad, Day 3, page 213)

Proposal 5 is Defective and Vague

As amended, Proposal 5 would price diverted milk, delivered to a plant located outside the marketing area, by a mileage calculation based on the distance between the plant of receipt and the nearest Order 5 or Order 7 distributing plant. On its face, the Proposal's language forces an arbitrary relationship between two plants that may have nothing in common. For instance, had Proposal 5 been in effect during November 2005, pooled and diverted Order 5 and Order 7 milk delivered to Northeast plants would have gained value because the Dean's Morningstar distributing plant at Mount Crawford, Virginia, became an Order 5 distributing plant. While it is hard enough to discern a reason why an in-area Order 5 producer's uniform price should decrease due to the increase of the value of Order 5 diverted milk at a Northeast plant, it is impossible to explain why an in-area Order 7 producer should have his price decreased for Order 7 diversions at Northeast plants because of the regulatory status of that Virginia plant.

If adopted Proposal 5 would open a Pandora's Box of unintended consequences and federal order gamesmanship. The SMA witness explained how to circumvent the proponent's intent by creating Order 5 or 7 supply plants outside the marketing area. (Exhibit 45) Creating out-of-area supply plants would be facilitated on Order 5 because that order contains a split plant provision, S.1005.7 (g) (6). While the SMA witness testified that market-place characteristics are requiring milk that additional supplemental supplies be located further from the market and provide balancing at the milk's source, Proposal 5 provides dis-economic incentives for building balancing facilities within the marketing area.

In Pre-Reform Order 5, there were five paragraphs defining out-of-area geographic exceptions before the two and one-half cents per ten mile zone-out was implemented for pricing diverted milk. Order Reform provided simplicity and standardization to the process of pricing diverted milk. The proponent would seem to want to return to a time when Federal orders included complicated provisions defining specific exceptions to generalized diversion rules. For instance, the proponent opined that the Secretary should acknowledge the intent of Pre-Reform Order 5 S1005.53 (a) (6), which priced diversions of Order 5 milk to plants located in the Pre-Reform Order 4 based on Class I price zones, if the Secretary chose to adopt Proposal 5. However, the proponent advised the Secretary, if he adopted Proposal 5 and considered this issue, that he should limit it to diversions to plants located in the old Middle-Atlantic Order 4 and presumably only diverted from plants located in the old Carolina Order 5. (Kinser, Day 3, page 152-4)

Land O'Lakes Recommends the Secretary Reject Proposal 5

While the demand and supply dynamics of the marketplace call for the pooling of a more-distant balanced milk supply, Proposal 5 would penalize those handlers that fulfill the markets' needs. If adopted, Proposal 5 would place an unnecessary financial burden on the handlers who balance the Southeastern markets with out-of-area sourced milk. The Proposal is defective and would lead to more complicated order diversion provisions. Federal Order Reform simplified and standardized the various marketing orders. When producers, located in Order 1, petitioned during the Reform process for a price surface for diverted milk different from the Class I pricing surface, the Secretary rejected that proposal. Land O'Lakes respectfully recommends that the Secretary reject Proposal 5.

Correction to Transcript: Day 3, Page 217, Line 18 should read: ". . . having Order 5 rather than Order 4. . ."