

**UNITED STATES DEPARTMENT OF AGRICULTURE
BEFORE THE SECRETARY OF AGRICULTURE**

In Re: :
: :
Milk in the Northeast, Appalachian, :
Florida, Southeast, Upper Midwest, : **Docket Nos: AO-14-A78, AO-388-A23,**
Central, Midwest, Pacific Northwest, : **AO-356-A44, AO-366-A52,**
Southwest, and Arizona Marketing : **AO-361-A44, AO-313-A53;**
Areas : **AO-166-A73, AO-368-A40,**
: **AO-231-A72 and AO-271-A44,**
: **DA-09-02, AMS-DA-09-0007**

**PROPOSED FINDINGS AND POST-HEARING BRIEF
FOR
NATIONAL MILK PRODUCERS FEDERATION**

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List of NMPF cooperatives (w/ volumes)

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I. INTRODUCTION AND OVERVIEW

This post-hearing brief is filed on behalf of the National Milk Producers Federation (NMPF) with respect to the proposals to amend all federal milk marketing orders which were the subject of public hearings held in Cincinnati, Ohio, May 5 — May 20, 2009. The twelve days of hearings involved testimony from 59 witnesses generating a transcript of nearly 4000 pages and 106 hearing exhibits. The primary issues in the hearing are whether the provisions for exemption of producer-handlers from the pricing and pooling provisions of the orders should be eliminated or revised and whether the provisions for exempt distributing plants should be amended.

The National Milk Producers Federation is the voice of America's dairy farmers, representing three-fifths of America's 60,000 commercial dairy farmers through their membership in NMPF's 31 constituent cooperative associations.

This brief will first summarize key aspects of the record by way of proposed findings of fact. The factual record will be reviewed and analyzed and legal issues presented by the proposals and the hearing will be discussed. The details and mechanics of the proposed amendatory order language will also be reviewed.

II. SUMMARY OF NMPF POSITION

The producer-handler exemption from pricing and pooling provisions of federal milk orders is a regulation which was born of expediency and a dangerous anachronism in today's marketplace. Exemption of producer-handlers from pricing and pooling under the orders is not mandated by the AMAA and under current marketing conditions throughout the order system it allows disorderly and inequitable market conditions which threaten the very viability of the order

system. The producer-handler provisions should be reformed by the adoption of hearing proposals 1, 2, and 26 which have four key elements: (1) eliminate the producer-handler category for any plants not in operation in 2008; (2) increase the exempt plant volume limitation to allow up to 450,000 pounds Class I distribution per month; (3) allow the continued exemption of producer-handler plants operating in 2008, and recognized as a producer-handler so long as the plant's monthly total distribution of Class I products is less than 3,000,000 pounds; and (4) prohibit exempt plants or the 'grandfathered' producer-handler plants from packaging products in a label used by any other handler.

The producer-handler exemption is 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. This record establishes that orderly marketing conditions in the 10 marketwide pools have been, or are in imminent danger of being, compromised by large producer-handlers. The large producer-handlers now operating represent a substantial volume of Class I sales removed from federal order pools. This reduces returns to all producers while retaining substantial Class I proceeds for each producer-handler on an individual handler "pool" basis. In Order 32, the Central Marketing Area representing the geographic heart of the federal order system large producer-handlers' reduce the marketwide blend price by more than \$.10 per hundredweight in many months. The same result can happen in any order in the system, without adoption of needed reform. This degradation of the uniform price(s) has cost pool producers millions of dollars. At the same time, the lack of uniform minimum pricing among handlers

competing for sales to customers ranging from large national and international chain stores to convenience stores to smaller local outlets undercuts the basis for the entire federal order system – which is the assurance of minimum class prices among all handlers.

Adoption of proposals 1, 2, and 26 will not impact the many small farmstead producer-handlers presently in operation, or future such operators. Increasing the exempt plant volume limit to 450,000 pounds will allow any producer whose production volume makes him a small business enterprise to be exempt from pricing and pooling provisions of the order if he chooses to process and market his own farm production as fluid milk products, providing that no product is distributed under the same label used by another handler. This labeling limitation is critical to assuring that pool handlers not be able to use exempt sources of fluid milk products to supplement or complement supplies to their customers/accounts. Use of single or multiple exempt plant sources to aggregate supplies under a single label could undermine the rationale for exempting plants from regulation – that because of their size they are not significant commercial factors in the marketplace.

Proposal 26 allows existing producer-handler plants to continue to operate without being subject to the pricing and pooling provisions of the orders so long as they remain in compliance with operating and ownership regulations and, in addition, (1) the plant's total (on all routes in all areas) monthly distribution of Class I products does not exceed 3,000,000 pounds and (2) the plant does not package any products using a label used by any other plant. Allowing existing plants to operate with these limitations provides a reasonable amortization of existing businesses.

III. PROPOSED FINDINGS OF FACT

A. Regulatory Background and Current Context

1. The origins of the producer-handler exemption.

1. The current producer-handler exemption began as a matter of expediency, not principle. (Cryan, Tr. 401-402)

2. The Federal Milk Marketing Order Program has its origins in the Agricultural Adjustment Act of 1933, which generally authorized the Secretary to enter into agreements with producers and to licensed handlers in order to restore normal economic conditions in the marketing of milk and milk products. The Department of Agriculture combined these powers to implement marketing agreements enforced by licensing in numerous markets across the country in 1933 and 1934. These licenses are the direct antecedents of the modern Milk Marketing Orders. (Cryan, Tr. 401)

3. The present exemption of the producer-handler traces its beginnings to Kansas City in the early 1930s. USDA Marketing Research Report No.14, dated May 1952, entitled Early Development of Milk Marketing Plans in Kansas City, Missouri, area, gives a detailed history of the events of that time. Official notice was taken of this publication. (Hearing Exh. 23, p. 3; Tr. 3970)

4. In the Kansas City market, producer-handlers sold 50 percent of the milk and cream consumed when the market's license was instituted in 1935. (Cryan, Tr. 401)

5. The 1935 license was intended to regulate the producer-handlers in the market. However, the Market Administrator encountered considerable resistance from a substantial number of producer-handlers who generally failed to submit reports and refused to make

payments to the equalization Fund when they did submit reports. Most of the rest followed suit when the Market Administrator failed to enforce these requirements on non-compliers. (Cryan, Tr. 402)

6. Successive amendments to the marketing agreement were made to lessen the burden on producer-handlers, but since no effective enforcement accompanied even these changes, non-compliance among producer-handlers continued to grow. (Cryan, Tr. 402)

7. In July 1935, the Department abandoned its attempts to regulate producer-handlers beyond reporting requirements. Producer-handlers were exempted from regulation as a matter of administrative expediency. This is the status that producer-handlers of all sizes enjoy today in all Federal Order markets. (Cryan, Tr. 402)

8. In August in 1935, Congress amended the Agricultural Adjustment Act to codify the previous practices of the USDA, re-establishing the licensing of handlers through issuance of Federal Milk Marketing Orders. (Hearing Exh. 23, footnote p.3)

9. These 1935 amendments include language “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 be equal to value of the milk purchased by him at prices” fixed by the USDA. Thus, the regulation of producer-handlers was specifically authorized and this language remains in the AMAA today. (Hearing Exh. 23, footnote p. 3)

10. The early difficulties in regulating producer-handlers gave way over the years to indifference about their regulation because of their generally shrinking numbers and small size. Even today, most potential producer-handlers fall under the 150,000-pound size exemption. (Hearing Exh. 20) It is the large producer-handlers, however, who have changed the landscape in

the marketplace. (Cryan, Tr. 403)

11. Producer and handler sizes have changed dramatically over the years and that has had an effect on the structure of dairy markets, at both the handler and farm level. Modes of transportation have changed, bulk tanks and bulk tank truck have changed the structure of milk assembly and distribution. Changes in packaging and equipment at the plant level, additional capital required to efficiently package product as required by consumers had an impact on the marketplace. Consumer buying habits have changed, including changes related to the growth of supermarkets and one-stop shopping and other similar changes have affected the structure of those markets. (Tonak Exh.)

12. USDA Market Administrator data shows that in May 2005, 513 out of 54,652 producers were larger than the 2.5 million pounds of milk production, accounting for less than one percent of the total of the population of federal order producers, but more than 21% of the production. ("Producer Structure in Federal Milk Orders, 2005", USDA, AMS Dairy Programs. Official Notice was taken of this document.)

13. In 2007, there were 595 dairy farms with over 2,000 cows, compared to only 235 just 9 years earlier when counts were first taken. A 2,000-cow dairy produces nearly 4,000,000 pounds of milk per month. The average farm in this category, according to national statistics, produced 6.6 million pounds per month in 2007, compared to 4.7 million pounds in 1998. (Cryan Exh. 23, p.4)

14. These very large farms, in excess of 2000 cows, now produce more than twenty-five (25 %) percent of the U.S. milk supply, a market condition that is quite different than in the 1930's. Producer-handlers of this size are large enough to utilize both the producer-handler raw

price advantage *and* economies of scale in fluid milk processing. Their share of production means that they could capture a large share of the Class I sales in an individual market or, in the worst case, nationwide if this loophole is left unremedied. (Cryan Exh. 23, p.4)

B. Current Marketing Conditions Involving Producer-Handlers.

15. Until recent years, there were very few large producer-handlers with the scale to compete primarily on price with regulated fluid milk handlers. Producer-handlers are today major competitive factors in sales of fluid milk products in many federal orders and potential major factors in all orders. (Findings 1–14, *supra*)

16. As of March 2009, there were 37 producer-handlers qualified in the Federal Order system. Of these, 5 are large enough to be directly impacted by the adoption of proposals 1,2, and 26. (Hearing Exh. 20)

17. Producer-handler Class I utilization is very high. Several of the large producer-handlers acknowledged Class I utilization in excess of 90%. (Keefe; Arkema) In Order 1, where the marketwide pool Class I utilization is just over 40% annually, the aggregate producer-handler Class I utilization is in excess of 75%. (Exh 61) In Order 32, with a marketwide pool Class I utilization of 37% in 2008, the aggregate producer-handler utilization is in excess of 70%. (Exh. 61)

18. The producer-handlers which would be impacted by the adoption of proposals 1, 2 and 26 are: Heartland Dairy, Order 32, Missouri; Country Dairy, Order 33, Michigan; Braum's Dairy, Order 32, Oklahoma; Aurora Organic Dairy, Order 32, Colorado; and GH Dairy, El Paso, Texas Order 126.

19. All of the producer-handlers which would be impacted by the adoption of

Proposals 1, 2 and 26 compete directly with regulated pool handlers for Class 1 sales.

20. Large producer-handlers are presently a major factor in all Orders. One large producer-handler with national distribution, Aurora Organic Dairy, is a competitive factor in all orders. The possibility of new, large producer-handlers is real in every order area. (Keefe Tr. 2968)

21. GH Dairy, in El Paso, Texas, which is presently qualified as a producer-handler¹, competes directly with regulated handlers including Price's Dairy in El Paso for all types of accounts including public school bid contracts and large grocery national/international accounts. GH Dairy's sales to accounts in competition with pool handlers have been at prices equivalent to \$4.00 per hundredweight below pool handler prices. (Carrejo Exh. 41, p. 6)

22. Braum's Dairy of Oklahoma operates 275 specialty dairy/grocery stores throughout a five (5) state area covering portions of Orders 32, 126 and 7. Its dairy product sales from its stores are directly in competition with sales from pool handlers. Braums moves its prices with the movements of Federal Order prices. (Bostwick Tr. 2983)

23. Braum's estimated monthly volume of producer milk is twenty million pounds per month. Braums has substantial Class II volume for ice cream and related products in addition to its Class I sales. (Bostwick Tr.2836, 2878)

24. Heartland Dairy of Missouri presently bottles milk from just less than three thousand cows with plans to increase in size, given its total herd size at present of 7,000 head.

¹ Mr. Hettinga's testimony at the hearing described, under oath, an ownership structure which does not qualify for producer-handler status, for lack of identity of ownership between processing and production facilities. (Tr. 2706-07) Either Mr. Hettinga's sworn testimony was not correct; or an error was made in recognizing GH as a producer-handler.

(Sharpe/Button Tr. 3662)

25. Heartland distributes fluid milk products in direct competition with pool handlers to a large regional grocery chains, the Hy-V stores, among other outlets. Heartland has gained sales in the Hy-V markets on the basis of price competition with pool handlers, including Anderson-Erickson and Prairie Farms. (Erickson Tr.2278-79; Lee Exh. 34).

26. Heartland distributes over a broad geographic area including Missouri, and portions of Illinois, Iowa, and into Kansas. (Sharpe/Button Tr. 3595)

27. Country Dairy of Michigan is a fourteen hundred (1400) cow producer-handler which markets more than 95% of its production as Class I sales. Country Dairy markets exclusively through a distributor which also handles product from pool handlers. (Arkema Tr. 3671-75)

28. Country Dairy, through its distributor, services regional convenience stores and grocery accounts as well as various other sales over a broad geographic area in Michigan and parts of Indiana, Illinois, and Ohio -- all in competition with pool handlers. (Wernet Exh. 77; Exh. 78)

29. Country Dairy historically has been very price competitive including using price as a means of increasing sales in periods of surplus. (Wernet Exh. 77, pp. 3-4; Arkema Tr. 3668-69)

30. Aurora Organic Dairy of Colorado produces organic fluid milk products from its fifteen thousand cow milking age dairy herd. Using average organic annual production per cow, Aurora's monthly production and the sales of Class I products are in excess of twenty million pounds. Aurora's herdsman has stated its annual production per cow to be 17,000 pounds. per

cow which would indicate average monthly production in excess of 21,000,000 lbs. (Arnold Tr. 1759; Keefe)

31. Aurora markets private label organic dairy products nationally with sales monthly in most Federal Milk Orders. (Keefe Tr. 2968)

32. Aurora's national competitors for private label organic fluid milk products are fully regulated pool handlers: Horizon Organic (Dean Foods); HP Hood; and Organic Valley (CROPP Cooperative). (Keefe Tr. 2936–37)

33. Testimony by individual organic producers, and cooperatives marketing organic milk, described the negative impact that such a single, national producer-handler can have on pricing for organic milk and milk products in all markets, undermining the prices received by pooled organic producers. (Arnold ; Segalla; Schilter; Berthiaume Exh. 27)

34. Aurora Dairies' processing plant was built in 2004. It is a "state of the art processing plant" with a total cost of over thirty five million dollars. (Keefe, Tr. 2908).

35. The threat of a large non-fully regulated producer-handler like Aurora is particularly acute in the organic market which is otherwise made up of smaller producers dispersed in all regions of the country. (Berthiaume Exh. 27; Segalla; Arnold; Schilter)

36. Bareman's Dairy in Michigan has experienced competition from unregulated producer-handlers. Bareman has lost sales over the years to producer-handlers on the basis of price. Bareman's Dairy has experienced seasonal pricing practices of producer-handlers over the years indicating a surplus management program. (Wernet Exh. 77)

37. Many dairy farmer cooperatives collectively invest in fluid milk processing facilities which are fully subject to marketwide pool and pricing regulations. Some of these

cooperatives include: Associated Milk Producers, Inc.; Dairy Farmers of America; Maryland and Virginia Milk Producers Cooperative Association; Midwest Dairymen's Company; Northwest Dairyman's Association; Prairie Farms Dairy; and Upstate Niagara Cooperative.

38. Large and small producer-handlers have demonstrated that they are able, when subject to marketwide pooling regulations, to compete. Heartland Dairy, for instance, began its operations as a pool handler for several years (Button Tr. 3604); Dakin Dairy in Florida is currently operating as a pool handler (Dakin Tr. 884-85); Diamond D Dairy in Colorado is operating as a pool handler (Docheff); Braum's Dairy has, of its own volition, opted in and out of full pool regulation and was not a producer-handler for a period prior to 2001 (Bostwick Tr. 2866); Edaleen Dairy in Washington, became a fully regulated handler after order amendments in 2004 and has continued in operation in Order 124 (Rowe); Sarah Farms in Arizona, in spite of dire protests of danger to its business from regulation, which occurred in 2004, has continued in business and is an active healthy competitor in Order 131 (Krueger 1364-69; Hettinga, Tr. 2726); Messrs. Montgomery and Bowers from southern Virginia operate a small farm and plant which is not qualified as a producer-handler, has been fully regulated in some months and has been continuously in business since 2001.

39. Marketwide pooling of Class I revenues is a fundamental element of the Federal Order System. Marketwide pooling of Class I revenues is the primary means by which small business dairy farms throughout the Federal Order System are assured a fair share of the Class I marketplace. (Hughes/Bothfeld Tr. 1089-90)

40. If marketwide pooling of Class I revenues is eroded by continued exemption from pooling of producer-handlers, small business dairy farms throughout the Federal Order System

will be at risk. (Berthiaume Exh. 27; Hughes/Bothfield Tr. 1089-90)

41. The data from the Order 32 Market Administrator shows the impact producer-handlers have (and could have) on even very large Federal Order pools. Exhibit 56 documents an impact from adoption of Proposals 1 and 2 ranging from \$.02 to \$.12 per hundredweight for the months of January 2008 through March 2009. Each \$.01 per hundredweight impact on the Order 32 pool represents a loss to pool producers of approximately \$ 100,000.00 (Exh. 56)

42. Even Order 1, the largest Class I Order in the Federal Order System, shows an impact of \$.01 - \$.02 per hundredweight per month (Exhibit 56, p. 7). Each \$.01 impact on the Order 1 pool costs pool producers about \$200,000.00.

43. Viewed in aggregate through the Federal Order system, Exhibit 56 compiled by the Federal Market Administrators, shows that producer-handlers presently have an impact on producer revenues which is of commercial significance. (Exh. 56)

44. Producer-handlers have a fundamental price advantage in making sales in competition with pool handlers because they do not have pool equalization obligations. The average amount of magnitude of the advantage varies from order to order and month to month but averages in the area of \$.15 or better per gallon. This is a substantial advantage when competing on the basis of price and sales to the same customers, particularly since wholesale prices for fluid milk products are routinely bid to the fourth decimal point – i.e. fractions of a cent per unit. (Cryan Exh. 23 ; Tonak Exh. 24, Att. 1)

45. When producer-handlers are not pooled the Class I value is lost to the Federal Order pool. The impact of these lost sales to federal order pools is calculated, in part, on Exh. 56 prepared by the Market Administrators, which show blend price impacts up to \$.12 per

hundredweight.

46. The producer-handler advantage can accrue to retailers who are aggressively seeking producer-handler suppliers. (Wilcox Exh. 39, pp 4-6)

47. A disorderly market in Class I retail sales exists where customers of producer-handlers compete with retail outlets supplied by fully regulated handlers. (Lee Exh. 34; Cryan; Hollon Exh. 104)

48. Retail supermarket stores do business in one of the most competitive environments in the American economy. Within that environment, fluid milk is one of the essential categories that determine the supermarket retailer's ability to effectively compete in the marketplace. (Wilcox Exh. 39, pp. 4-6)

49. Disorderly marketing affecting producers and their cooperatives can occur in either the market for raw milk or in the market for bottled milk.

50. A retailer can purchase from a producer-handler until that producer-handler can no longer supply the milk needed by such retailer for a given period, then that retailer can turn to the regulated handler to get its remaining supply needs. In such a case the burden has been placed upon the regulated market to provide the balancing for that product and the producer-handler is a free rider on the pool.

51. Another way in which producer-handlers balance with pool supplies is by providing only certain sizes or types of containers when supplying distributors or stores which also handle supplies from pool handlers. (Gilbert Tr. 2470).

52. Large retailers today are sophisticated buyers which recognize the cost/price advantages of a producer-handler source of Class I products. Retailers have sought out dairy

suppliers to become producer-handlers; and have actively sought existing producer-handlers for suppliers. Small fully regulated dairies have been solicited to combine with large farms in a producer-handler enterprise. (Wilcox Exh. 39; Dewey Exh. 79, p. 2)

53. The capital required to build or buy a processing facility is much less than that required to purchase a farm and dairy cattle to supply the plant. Where the cost of a plant may be \$10 million dollars, the cost of the dairy farm to supply the plant would be closer \$40 million. Large modern dairy farms have an economic incentive to become producer-handlers; plants have an economic incentive to seek out producer-handler supplier rather than vertically integrate backwards. (Wilcox Tr. 1307)

C. The Need for Revised Regulations: The Advantages of Large Producer-Handlers

1. The fundamental producer-handler advantage.

54. Federal Milk Orders achieve their objectives by doing five things: (a) classify 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) set and enforce uniform minimum class prices among handlers.

55. A producer-handler, by avoiding Federal Order regulation as a distributing plant, can pay, effectively, a uniform price for milk at the plant. As the market price for producer milk on the market, the uniform price is the appropriate transfer price for analysis of vertical integration. Its regulated competitors pay the Class I price for the same milk. Pooled producers receive the uniform price. (Tonak Exh. 24; Cryan Exh. 23)

56. The producer-handlers have a pricing advantage over pooled handlers and producers that is equal to the difference between the plant's average value of milk and the value of the same volume at the pool blend price. That is to say, it is equal to the payment to the producer settlement fund that the handler avoids by maintaining producer-handler status. For a plant with nearly 100% Class I use, this can approach the difference between the Class I and blend prices in the market. This can reach an upper limit of about 15¢ per gallon, although this can grow to be much larger in some months, depending on that month's price relationship. (Exh. 23, p.23)

57. The large producer-handler has production cost advantages on the producer side. Large farms in the federal order system with over 2,500,000 pounds of monthly production now produce more than 20 percent of the milk pooled in federal orders, which is equal to more than 55 percent of fluid (Class I) milk volume. These shares are steadily increasing. (Cryan Exh. 23 ; Hollon Exh. 104)

58. The larger dairy operation has the ability to market tanker load quantities of milk every day, which is a clear, competitive advantage from a milk marketing standpoint, over the typically-sized producer-handler that might produce 1/10 of a tanker load per day. The larger dairy operation is in a much more favorable position to consider the application of on-farm milk concentration technologies, reverse osmosis, and ultra-filtration as another means of effectively matching their milk production more closely with their local market needs, while having the flexibility to move concentrated milk to more distant markets in a cost effective manner. (Tr.)

59. The management structure of larger dairy operations certainly provides a capacity for these operations to leverage this more specialized management expertise throughout the business from operations, dairy, and processing, through to the marketing of a quality, finished product. In addition to capturing the economies of size at the milk production level, handlers 3 million and above can capture economies of size associated with the larger processing capacities.

60. The ability of producer-handlers producing and marketing milk in excess of the proposed 3,000,000 pounds per month limit should not present a large economic disincentive for those producer-handlers that will be affected.

61. Large producer-handlers can take advantage of economies of scale in milk production and processing. s and are not leaving the business. (See Erba, Eric, Richard D. Aplin, and Mark W. Stephenson, *An Analysis of Processing and Distribution Productivity and Costs in 35 Fluid Milk Plants*, Research Bulletin 97-03; and Dalton, T.J., G.K. Criner, and J. Halloran, "Fluid Milk Processing Costs: Current State and Comparisons." *Journal of Dairy Science* Volume 85, No. 4 (April 2002) pp. 984-991., both noticed at Tr. 3970. See also USDA ERS Statistical Bulletin No. 974-6 "Characteristics and Production Costs of U.S. Dairy Operations," February 2004, noticed at Tr. 3969)

2. **The nature of competition between unregulated producer-handlers and regulated handlers and pooled producers.**

62. The current Federal Order regulations provide the unregulated producer-handler with the significant cost advantage that cannot be matched by handlers that are regulated. (Shamrock, Carrejo, Bareman, Lee, Chrissy Dewey, Gary Latta, etc?)

63. Today's largest producer-handlers are vertically integrated, competitive forces in

the fluid milk industry; serving large wholesale customers.

64. An exempt plant, and in particular, the producer-handler plant, enjoys a significant and competitive advantage over other producers and other handlers in the market. As a producer, the exempt producer-handler can receive more than the blend price for his milk depending on his internal transfer price between his plant and his milk production activity. As a handler, the exempt producer-handler can pay less than the Class I price for his milk supply.

(Wilcox; Cryan; Hollon; Yonkers)

65. Producer-handlers routinely make price changes to customers directly in line with changes in the Federal Order price to the milk.

66. Of the more than 30,000 small business producers represented by NMPF cooperatives the changes in regulations would effect them in two ways. First, it would improve their income by the amount which would be paid into the pool by presently unregulated producer-handlers. However, the larger issue is the continued existence of the Federal Order system. The much greater potential impact is the loss or undermining of the Federal Order system. That would have a major impact on all small business farmers in the federal order system. (Cryan Exh. 23)

67. The producer-handler exemption violates the principles of producer equity upon which the Federal Orders rest. In the best case, which is vertical integration of efficient milk production with efficient milk processing, the producer-handler exemption robs the producer pool to pay producer-handlers. (Cryan Exh. 23 ;

68. In the worst case, which is the uneconomic reorganization of farms into producer-handlers, the exemption also creates deadweight losses in the market whose whole cost is born

by pooled producers. (Cryan Exh. 23)

69. There is widespread awareness among regulated producers and handlers that the producer-handler exemption, if it is allowed to exist unchecked as it is at present, will lead to the disintegration of the entire Federal Order system and consequently, to chaotic milk markets across the United States. (Cryan; Hollon; Yonkers)

70. Dairy farmer members of the NMPF cooperatives marketing under the Federal Orders recognize that continued, unlimited federal exemption for producer-handlers from pricing and pooling threatens the effective operation of the Federal Order system and the loss of the benefit provided to dairy farmers. (Cryan Exh. 23)

71. The outcome of allowing the current regulatory inequity to stand unchanged is that customers will demand to buy milk at costs similar to what large producer-handlers can provide to their competitors and there will have to be an expansion of unregulated suppliers to satisfy those customer needs. Regulated distributing plants will not be able to survive in the system; they will not be able to compete effectively if the producer-handler exemption is not changed. Alternatively, they will have to become exempt from the system, by becoming a producer-handler, in order to continue to survive.

D. Support for the Proposals 1, 2, and 26 and Their Basic Provisions

72. The National Milk Producers Federation, which is one of the proponents of proposals 1 and 2 and the proponent of proposal 26, represents three-fifths (3/5) of America's 60,000 commercial dairy farmer through its 31 constituent cooperative associations (Ex. 23; see Attachment 1 to this brief).

73. Lakeshore Federated Cooperatives, which is a group of four cooperatives in Order 30, which includes cooperatives which are not members of National Milk Producers Federation supports the NMPF proposals for regulation of producer-handlers and exempt plants. (Tonak Tr. 515-16).

74. The International Dairy Foods Association (IDFA) represents the vast majority of the dairy product processors including the overwhelming majority of fluid milk plants in the Federal Order System. It supports proposals 1 and 2 which were jointly submitted by IDFA and NMPF. (Yonkers Exh. 80)

75. A number of individual members of National Milk Producer Federation and IDFA testified at the hearing to provide further support to the associations' positions in this hearing. These participating individual companies included: St. Albans Cooperative Creamery of St. Albans Vermont; Northwest Dairyman's Association, Seattle, Washington; Dean Foods Co.; Prairie Farms Dairy; Midwest Dairyman's Association; Maryland and Virginia Milk Producers Cooperative Association, Inc.; Michigan Milk Producers Association; United Dairymen of Arizona; Dairy Farmers of America, Inc.; Worcester Creameries, New York; Northeast Dairy Foods Association; Select Milk Producers, Inc. and Continental Dairy Products, Inc.; and Anderson Erickson Dairy.

76. In aggregate, the overwhelming majority of the industry, from all Orders, both producer and processor, as well as the representatives of four of the largest dairy farm states in the Federal order system, testified to their belief that the Federal Order system needs amended to more appropriately deal with producer-handlers and exempt plants. This represents a mandate from the industry to bring Order regulations in line with the current marketplace realities of

producer-handlers. (Yonkers Exh. 80; Cryan Exh. 23; Hughes/Bothfield Tr. 1112-1117)

77. Federal policies for the support of small business enterprises will be furthered by adoption of proposals which regulate large producer-handlers and thereby preserve the integrity of federal order pools the overwhelming majority of participants in which are small business dairy farms.

78. Proposals 1, 2, and 26 are designed to achieve regulation of those producer-handlers which are presently disrupting the federal order markets to an extent that is damaging to the operation of the Orders and, therefore, to all producers' interests. Upon adoption of Proposals 1, 2, and 26, five to seven current producer-handlers will no longer be recognized as producer-handlers and will, therefore, no longer be exempt from pooling and pricing under the federal orders. So long as they conform with the labeling limitations in Proposal 2, the remaining current producer-handlers will either have exempt plant status (if marketing less than 450,000 pounds per month) or retain producer-handler status so long as they operate within the existing producer-handler restrictions and do not market more than 3,000,000 pounds of Class I products per month.

79. Proposals 1, 2, and 26 have four (4) primary aspects: (1) Elimination of the category of producer-handler for all persons and entities not presently so-regulated; (2) increasing the volume limitation for exempt plants to 450,000 pounds of Class I sales per month; (3) allowing existing producer-handler plants to continue in operation so long as **total** monthly Class I disposition is less than 3,000,000 pounds; and (4) requiring that all Class I products of producer-handlers and exempt plants be uniquely-labeled – i.e. not using a label which is also used by any other plant.

IV. ANALYSIS AND CONCLUSIONS

NMPF asserts that the facts on record demonstrate very clearly disorderly marketing conditions associated with the current producer-handler regulations. The small and large producers who NMPF represents, and the cooperative businesses that they operate, are required to play by one set of rules, while large producer-handlers are able to play by another set of rules that tilts the playing field greatly to their advantage.

Producer-handlers do not pay into the Federal order pools. The larger producer-handlers clearly have an impact on the rest of the market, especially since there are many ways in which they can impose their balancing needs on the rest of the market. The number of large producer-handlers is growing, and a failure to regulate them in this hearing will only accelerate this growth.

NMPF and the International Dairy Foods Association jointly submitted Proposals 1 and 2 to address these disorderly marketing conditions, and those proposals initiated this proceeding. NMPF subsequently submitted an additional proposal, proposal 26, which complements those initial proposals. Together, these proposals are intended to establish more equitable rules for dairy farmers in all regions and of all sizes. They will result in the additional regulation of only 5 handlers, all of whom have annual sales of at least \$10 million, at 2008 prices. Dozens of smaller exempt plants and producer-handlers would remain unregulated or subject to less regulation; hundreds of pool plants would benefit from more orderly marketing; and thousands of producers would benefit from increased uniform milk prices. More importantly, the entire industry will benefit from preventing the continued growth of large, unjustifiably exempt producer-handler plants.

A. Current Regulation of Producer-Handlers

The Agricultural Marketing Agreement Act of 1937 specifically authorizes the regulation of “producers who are also handlers.” It is clear from the legislative history of the legislation reauthorized by the Agricultural Marketing Agreement Act of 1937 (cited above) that Congress intended for marketing agreement and marketing order programs to regulate producer-handlers whose volume “is large enough to be an important factor in the market,” since their “cooperation is necessary to carrying out the marketing plan.” (Amendments to Agricultural Marketing Agreement Act: Hearing before the Committee on Agriculture, House of Representatives, 74th Congress, First Session on HR 5585-Serial E.)

The Agricultural Marketing Agreement Act of 1937, as amended, 7 U.S.C. 608c(5)(C) provides:

“In order to accomplish the purposes set forth in paragraphs (A) and (B) of this subsection (5), 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 purchases by him at the prices fixed in accordance with paragraph (A) hereof.” [Emphasis added.]

Producer-handlers were originally given special status for administrative reasons, not on legal principles. This expediency, intended to avoid confrontation with a group of small producers in one marketing order, became institutionalized in all Federal milk marketing orders. This largely unregulated status was, until recently, available to producer-handlers of all sizes in all Federal order markets. (Exh. 23, pp. 2-3; *Early Developments of Milk Marketing Plans in the Kansas City, Missouri, Area*. 1952; USDA.)

In 2003, proposals were made to limit the potential size of producer-handlers in the

Arizona and Pacific Northwest markets. In 2005, those proposals were accepted by USDA, which issued a final rule in 2006 that limited the producer-handler provisions in those milk marketing orders to entities that produced no more than 3 million pounds of fluid milk sales per month. (71 Fed. Reg. 9430).

B. Large Producer-Handlers Cause Disorderly Marketing

Producer-handlers disorder marketing as a result of their regulatory pricing advantage, vis-à-vis otherwise comparable regulated handlers. Their impact on the rest of the market is the same as that of an individually pooled handler alongside a marketwide pool.

A producer-handler, by avoiding full Federal order regulation as a distributing plant, can avoid paying into the producer settlement fund. In one sense, the plant pays the uniform price (plus current premiums, if any) for milk at the plant, since that is what its farm milk would be worth if sold to another plant. Fully regulated competitors, by contrast, must pay the Class I price for the same milk.

In his testimony in the present hearing, Dr. Cryan made it clear that assessing the impact of a producer-handler on the market does not depend on establishing a transfer price, and focused instead on comparing the regulatory cost of a producer-handler with that of a comparable pairing of farm and plant.² The costs a producer-handler faces are no different than those faced by a

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The market price for producer milk on the market is the appropriate transfer price for analysis of the regulatory impact on the producer handler plant. However, in the producer-handler hearing for the Arizona and Pacific Northwest Markets, there was considerable discussion of the appropriate transfer price between the farm and plant within a producer-handler operation. This concept can aid analysis of the producer-handler issue, but it did not appear to enter into USDA's decision in that hearing, and is sometimes more confusing than enlightening. Dr. Knoblauch testified that Federal orders do not provide uniform prices for all producers, without qualification. That is, he considered variation in producer milk prices without considering the corresponding variations in Federal order prices, with respect to component tests and location, and without considering other price differences based on substantive differences in milk and marketing costs, including quality premiums and volume premiums. (Knoblauch, TR. 3308-3314) Similarly, Dr. Knutson argued that the Federal order prices are not relevant to the price paid to producers, although he was obliged to admit that they certainly defined this pool obligation. (Knutson, TR. 3342-

regulated farm and plant, other things being equal, except that the producer-handler does not pay into the producer-settlement fund. (TR. pp. 1692-1693)

The advantage that the producer-handler has, compared to the regulated producer and handler, is the payment to the producer settlement fund that the regulated handlers makes but the producer-handler does not. That payment is equal to the difference between the average value of milk used in the plant and the uniform price, which is the average value of pooled milk used in the market. For a bottler with Class I use near 100%, this would approach the difference between the Class I price and the uniform price. In 2008, the annual average of this advantage ranged from 6¢ to 15¢ per gallon (or 72¢ to \$1.74 per hundredweight). The difference between the Class I price and the uniform price at the base point will equal the difference between Class I and the uniform price across the market, since both are adjusted by the same location differential.

This is a very substantial advantage for large producer-handlers who may reasonably be assumed to have no corresponding disadvantage in cost or opportunity.

One of the original assumptions underlying the decision to permit a special producer-handler status was that these operators had limited supply and marketings, and would remain so small as to not have a significant effect on the market. Over time, this has proved to be a faulty assumption. Changes in the industry, in technology and in the economics of the dairy business have drastically reduced the number of producer-handlers; these same changes have drastically increased the size and market potential of those remaining. Some producer-handlers have grown

to become much larger than could have been imagined 70 years ago.³

While most (87 out of 117) potential producer-handlers today still fall under the 150,000 pound size exemption, this is rapidly changing. (Exh. 20) Until recently, the substantial growth in the scale and efficiency of large fluid milk processors meant that even the largest farms were unable to take advantage of the scale economies; with relatively high unit costs, producer-handlers did not proliferate, and in fact, they declined in number and volume processed. (Exh. 7.)

But this is no longer the case. Today, fewer than 600 farms now produce over one-quarter of the U.S. milk supply, equal to nearly 80% of all sales of fluid milk products in the U.S. (*Milk Production*. USDA/NASS, February 2000, February 2008; *Farms and Land in Farms*. USDA/NASS, February 2008; *Federal Milk Marketing Order Statistics 2007*, USDA/AMS. See Exh. 23, p. 4.)

Many dairy farms are now large enough to exploit both the producer-handler raw milk price advantage, which is described below, and to enjoy economies of scale in both milk production and fluid milk processing. Collectively, they could capture a large share of the Class I sales in an individual market or nationally, if many of them adopted this model. This would be disastrous for small pooled dairy producers whose blend prices would be substantially cut.

There are 17 producer-handlers with route sales in excess of 300,000 pounds, including 7 with route sales above 2,000,000 pounds, and the average producer-handler has grown from an average of 34,645 pounds of Class I sales in October 1959 (production from about 60 cows at

³ In 1947, for example, four different Federal milk orders each pooled less than 3,000,000 pounds of producer milk per month. (*Federal Milk Order Market Statistics, 1947-56*. Agricultural Marketing Service, USDA. 1959; see Exh. 23, p. 4)

that time) to an average of 1,422,080 pounds in December 2008 (milk from about 720 cows). (Exhs. 7, 20) The sales of the 7 largest producer-handlers are estimated to average at least 80 million pounds per year per plant. (Cryan, TR. 1874)

The hearing on producer handlers in the Arizona and Pacific Northwest markets demonstrated the potential disruption that large producer-handlers can inflict, individually and collectively, on orderly marketing, finding specifically that large producer-handlers in those markets were “the primary source of disruption to orderly marketing of milk.” (70 Fed. Reg. 74186) Producer-handlers also have a significant and growing share of Class I sales in several markets, including the Northeast, Central, and Southwest markets. (Exh. 12A) Producer-handlers in the Central order, with estimated total sales of more than 27 million pounds per month, have between 10% and 15% of the Class I sales by handlers in that market. (Exh. 9; Findings above regarding the volume of Heartland Dairy, Aurora Dairy, and Braum’s Dairy) USDA data presented at this hearing also show that producer-handlers make up a growing share of sales in market where they are present and unaffected by recent restrictions. (Exh. 6)

As producer-handlers become large enough, their advantage in terms of their cost of milk can become the primary basis for their existence as handlers. A large producer-handler can now enter the bottling business, even if it is not competitive in its processing costs, purely because the disparity in the regulatory scheme creates an advantage.

As producer-handlers get larger, their regulatory status increasingly undermines the principles of producer equity and orderly marketing upon which the Federal order system rests. In the best case (vertical integration of efficient milk production with efficient milk processing), the

producer pool is depleted to pay producer-handlers. In the worst case (uneconomic reorganization of farms into producer-handlers), the current system creates deadweight losses in the market whose whole cost is borne by pooled producers. For example, a producer-handler could be up to 15¢ per gallon less efficient than the competition would otherwise require, and still be viable.

NMPF concludes that the 2 largest producer-handler plants have sales in excess of 15 million pounds per month, and that the 7 largest producer-handlers average 80 million pounds of fluid milk sales per year.⁴ (Cryan, TR. 1874)

These average sizes for producer-handlers understate the impact of the largest ones. A bimodal distribution of producer-handlers is developing, with large and shrinking numbers of small plants on one node, and a large and growing share of producer-handler milk being sold by a modestly growing number of large producer-handlers on the other. Again, it is estimated that the 7 largest producer-handlers have an average of at least 80 million pounds in fluid milk sales per year, for a total of 560 million pounds for all 7. Adding an estimated 48 million pounds (4 million pounds per month) for GH Dairy to the 2008 sales total gives about 626 million pounds of annual sales by current producer handlers. This means the 7 largest account, conservatively, for 90% of the total sales by producer-handlers. (Exh. 12A; Carrejo, Tr. 1449. See also attached calculation of producer-handler volumes.)

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In NMPF's testimony at the hearing, Dr. Cryan assumed that GH Dairy was processing some 16 million pounds per month, based on the volume reduction of fluid sales by F.O. 126 pool handlers between December 2008 and January 2009, compared to the month to month change a year earlier, and based on published accounts of the number of cows on farms associated with the plant. It will be taken on credit that the monthly sales are presently 4 million pounds per month, per the testimony of Mr. Carrejo (Carrejo, Tr. 1449), though it is noted that Mr. Hettinga's testimony strongly suggested his willingness and ability to expand the volume of the GH Dairy plant in El Paso to 35 million pounds per month. (Hettinga, Tr. 2723-2725)

Raw numbers of producer-handler fluid milk sales show a 12% decrease from 2004 to 2008. However, this decrease has been primarily the result of needed changes in producer-handler regulation and the termination of the Western Federal Order. Three large producer-handlers, Sarah Farms (estimated 17 million pounds of sales per month), Edaleen Dairy (minimum 3 million lbs./mo.), and Smith Brothers (minimum 3 million lbs./mo.), became subject to regulation as pool distributing plants in 2006, and the Western Federal Order was terminated mid-year 2004. Together, these three plants plus the producer-handlers in the Western Order accounted conservatively for 280.6 million pounds of producer-handler fluid milk sales in 2004. Subtracting that volume gives an adjusted 2004 baseline of at least 378.2 million pounds of fluid milk sales by producer-handlers, per the current Federal order regulations. In 2008, producer-handler fluid sales were 578.3 million pounds, this is a 52% “apples-to-apples” increase in only 4 years, despite a decline in the number of producer-handlers. (Exh. 12A and 74; Cryan, Tr. 2034-2039)

A similar “apples-to-apples” comparison can be found in Exhibit 6, in which the producer-handler volume (for those 8 Federal order markets for which producer-handler regulation has not changed) has risen by nearly 60% in 6 years.

This demonstrates very clearly the trend, and the growing potential, for a small number of very large producer-handlers to substantially disrupt order marketing through a growing market share taken at the expense of pooled plants and pooled producers. This growth in the volume handled by large producer-handlers has clearly been driven by the attractiveness of their exemption from pooling and pricing and several producer-handlers indicated their reliance on the pricing exemption. (Shatto, TR. 1206; Rooney, TR. 1519; Flanagan, Tr. 2513; Kreider, TR.

2632.)

The retail grocery business is very price-driven. Several witnesses testified to the ability of large producer-handlers to exploit the pricing advantage of their pool exemption to underbid pooled handlers, and to the rippling effect that such an advantage has on contracts with other retailers, leading to pricing that undermines Federal order pricing. In addition to the numerous advantages naturally associated with vertical integration (cited by witnesses for Aurora Dairy and GH Dairy), they were also granted an exemption from Federal order pooling, based on an outdated conception of the nature of the producer-handler. (Bostwick, TR. 2832, 2838; Hettinga, TR. 2693; Cryan, TR. 1704-1705; Lee, TR. 947; Krueger, TR. 1358-1359; Carrejo TR. 1448-1453; Wernet, TR. 2310.)

Mr. Erickson, from Anderson-Erickson Dairies, testified that Heartland Dairy grew by exploiting its exemption to sell a large chain store its discount store brand. He also stated that Heartland would undercut the price of any current supplier by an amount made possible by their regulatory pricing advantage, demonstrating that the producer-handler pooling exemption allows them to compete in any market niche, from high to low. He also indicated that Heartland would undercut existing suppliers prices by a given amount. He testified to the effect that this has had in undercutting market prices in Central Order. (Erickson, TR. 2300)

In cross-examination, the witness from Bareman's indicated that it lost accounts to their producer-handler competition on basis of the producer-handler's lower price, then regained the accounts on the basis of Bareman's superior service. (Wernet, TR. 2356) This demonstrates how a business that operates less efficiently can gain business on the basis of regulatory price advantage, imposing its deadweight losses on the pool and its competition.

Several processor witnesses noted the sophisticated nature of retailers with regard to milk pricing regulations and that most retailers were well aware of the producer handler advantage. A witness for Harrisburg Dairy noted being approached to become a producer handler and Mr. Wilcox testified about being recruited by a retailer to become a producer handler. (Dewey, TR. 2370; Wilcox, TR. 1300) This retailer-initiated move to producer-handler status demonstrates one possible form of the “integrator” model, in which large retailers serve as the integrator of smaller producer-handlers that they recruit.

The “Nourse Report”⁵ was cited by Dr. Knutson in support of the continued exemption of producer-handlers, based on its definition of “orderly marketing”. Dr. Knutson did not recall, however, that the Nourse report stated specifically that

Historically, exemption from regulation has been given to certain handlers, particularly public-owned processors and producer distributors. Little justification exists today for exemption from regulation and only under the most unusual circumstances, should such exemptions be granted. (p. 57, December edition)

Dr. Knutson appeared on behalf of A.I.D.A. in support of Proposals 23, 24, and 25. He dismissed these conclusions of the Nourse Report as inadequately explained. (Knutson, TR 3195) However, the Nourse Report explains the overall need for regulation and marketwide pooling, and simply found “little justification” for such exemptions as those granted to producer-handlers (then generally referred to as “producer distributors”). (Nourse Report, pp. 64-65, December edition) Having proven the positive, the Report did not require a disproving of the negative.

This leads directly to the Nourse Report conclusion that individual handler pools tend to disorder marketing. (p. 43, December edition) Individual handler pools are discussed in detail

⁵ This is formally titled Report to the Secretary of Agriculture by the Federal Milk Order Study Committee, and finally published in December 1962; this December edition was cited and referred to during cross-examination of Dr. Knutson by Mr. Tosi.

below, in connection with Proposal 25; however, it is important to recognize the very substantial similarities of the producer-handler to an individually pooling handler. The Nourse Report also states that “Elimination of price difference between handlers for milk used in the same class eliminates one of the prime incentives for disorderly marketing.” (p. 42, December edition) The difference the obligation to the producer settlement fund, between regulated handlers and producer-handlers, represents a difference in the price they pay for milk used in the same class, and contributes to disorderly marketing in the very same way.

Further, producer-handlers, despite not contributing to the producer settlement fund, impose balancing costs on the rest of the market. Although the witness from Aurora Dairy insisted that producer-handlers can and do balance their own supply, this conclusion was based on a fundamental misunderstanding of that proposition. In fact, her testimony demonstrated various ways by which Aurora Dairy imposes its balancing burden on the larger market. Specifically, Aurora manages its balancing through multiple means, including, “production of powder and butter at co-packers” and “bulk sales,” both means of going around Federal order regulation to dispose of surplus and acquire supplemental supplies of complementary lines of manufactured products. In addition, she stated, “It is always the case that our customers have alternative suppliers,…” including, presumably, pooled handlers of organic milk. (Keefe, Tr. 2909-2910)

Many of the producer-handlers who testified demonstrated the ways in which they could impose the balancing burden on the rest of the market. Mr. Bostwick, for example, demonstrated a clear awareness of his ability to use price to regulate his customers’ demand for his milk, in competition with the rest of the market. (Bostwick, TR. 2890)

These are very clear demonstrations of the practical impossibility of forcing a producer-handler to truly balance its own supply and demand without having an impact on the rest of the market. The larger these handlers get, the more sophisticated their methods become. These methods can be made more expensive, incurring deadweight losses that are subsidized by the pool through the producer-handler's inequitable pooling exemption.

Witnesses for producer-handlers tried to show that de-pooling is very destabilizing, with the implication that if de-pooling is allowed, then so should producer-handlers. We acknowledge the problems of de-pooling and note USDA and the industry have taken significant steps to address the issue in a number of markets. That is another issue, though, being addressed in another venue.

However, the raising of the issue does underline the similarity of adopting producer-handler status to depooling. Producer-handlers choose to absent themselves from the Federal order pool in order to take advantage of "disadvantageous price relationships," just as depooling manufacturing plants do. The witness for Braum's Dairy, for example, testified that they chose to adopt producer-handler status after Federal order reform, due to changes in the relationship between the F.O. 32 uniform price and their plant's value of milk. This is, in effect, a destabilizing, even if somewhat more consistent, depooling of values that would otherwise be represented in the Federal order pool. (Bostwick, TR. 2866)

When Class prices are in a normal relationship to one another, the Federal order system naturally requires pooling of Class I handlers and allows depooling of manufacturing milk. Depooling of manufacturing milk has only been a problem due to the volatility of prices and the use of lagged pricing for certain Classes. By contrast, the relative constancy of the depooling of

producer-handlers merely disguises their substantial contribution to disorderly marketing.

Perhaps more importantly, witnesses for producer-handlers frequently expressed their desire to do away with the entire Federal order system, despite the advantages it offers them through their exemption from pricing and pooling, and generally showed little regard for the objectives of the Federal order system. This is consistent with their support for individual handlers pools (Proposal 25) and their desire to continue in the generally disruptive role that producer-handlers play under current regulation. (Oberweis, TR. 2420-2422, et al.; Hettinga, TR. 2746.)

C. Proposal 1. Eliminate Special Status for Producer-Handlers.

NMPF seeks to eliminate the producer-handler provisions in all Federal orders, so that producer-handlers are treated like all other handlers. Treating producer-handlers like other handlers is equitable and consistent with the both the letter and the original intent of the law, and it is the remedy for the disorderly marketing demonstrated by the current record.

Producer-handler provisions increasingly threaten orderly marketing. As stated above, about 600 farms now each produce more than 4 million pounds of milk per month, 25% of the U.S. milk supply and the equivalent of 80% of U.S. fluid milk sales. Some 1500 farms with over 2 million pounds of monthly milk production account for 42% of U.S. production, equivalent to 140% of total fluid sales. The number of large farms is steadily increasing, and their impact on other dairy farmers is becoming more significant. Because of the potential for these large farms to exploit the advantages of the current producer-handler provisions, tens of thousands of smaller dairy farms, and the handlers who purchase their milk, are now potentially threatened.

1. The Need to Eliminate the Producer-Handler Provisions

There is no legal or economic justification for producer-handler provisions, and the Federal order objective of orderly marketing demands their elimination. In its December 14, 2005, final decision for the Arizona and Pacific Northwest Markets, USDA stated that, “Review of the intent of the producer-handler provision and the marketing conditions arising from this provision in these orders could warrant finding that the original producer-handler exemption is no longer valid or should be limited to 150,000 pounds per month Class I route disposition limit. However, the hearing notice for this proceeding constrains such a finding to a level of not less than 3 million pounds per month of Class I route dispositions.” (70 Fed. Reg. 74186)

NMPF agrees with USDA’s conclusion that producer-handler provisions are an anachronism, and urges USDA to act on this conclusion in the present proceeding, whose scope is clearly defined to include the entire elimination of producer-handler provisions.

NMPF proposes to limit producer-handlers to the same size exemption as other processors. In some Federal order markets, large producer-handlers already capture a significant share of Class I sales, undermining the pool value at the expense of producers and pool handlers. Reform of the system is a matter both of equity and of orderly marketing.

Although several Federal order markets are not now substantially disrupted by the operations of large producer-handlers, it is good policy to establish uniform provisions which address this issue proactively, before such a clearly foreseeable problem develops. This proactive approach minimizes the burden of regulation by laying out the rules in advance. The proposed changes would simplify and clarify the responsibilities of current producer-handlers,

relaxing the regulatory constraints on their operations, and directing the largest of them to participate in the Federal order pool.

The original reason that the producer-handler provisions were established – i.e., the inability of market administrators to enforce compliance – is certainly no longer valid. The regulation of large producer-handlers would now be no more difficult than that of other handlers, and would restore the principle of marketwide pooling, upon which the Federal orders are based.

D. Proposal 2: Expanding and Reforming the Exemption for Small Distributing Plants

NMPF also proposes to raise the size limit for exempt plants from 150,000 pounds of monthly Class I sales in an individual market to 450,000 pounds of monthly Class I sales in all markets. This is a distinct proposal, but effecting it concurrently with the elimination of the producer handler provisions can avoid unduly affecting other producer-handlers who have a limited individual impact on the market. Proposal 1 and Proposal 2 would exempt all but the 10 to 15 largest current producer-handlers, as well as 30 to 35 plants that are now regulated or partially regulated.

Today, any plant with less than 150,000 pounds in monthly Class I sales is exempt from Federal order regulation. Given the growth in average farm size, and the growing economies of size in milk processing, it is reasonable to increase the size exemption to 450,000 pounds per month. For perspective, this is equal to the production of about 260 cows, or twice the size of the average dairy herd in the U.S. Plants this small have difficulty competing with large modern plants on cost alone, with or without the pricing advantage offered by producer-handler status.

The farm bottling is the most common model for such small fluid handlers, and expanding the size exemption is an appropriate means of relaxing regulation for producer-handlers that are too small, with attendant costs that are too high, to effectively compete on price with regulated handlers receiving milk from pooled producers.

NMPF urges USDA to consider this increase in the small plant exemption concurrently with NMPF's proposal to eliminate the producer-handler provisions. The principle of raising the limit is sound, and the coincidence of the two proposals will mitigate for most producer-handlers the regulatory impact of eliminating the producer-handler provisions of the orders.

1. Origin of the Current Exempt Plant Size Limit

Today, any plant with fewer than 150,000 pounds in monthly Class I sales is exempt from Federal order regulation. This limit was made uniform for all orders during Federal order reform. The proposed rule, published in 1998, stated:

“Options 2 and 3 both recognize the Identical Provisions Committee determination than [*sic*] a handler distributing less than 150,000 pounds per month of fluid milk products does not have a significant competitive effect on the market, and that handlers of such size should, therefore, be exempt from the pricing and pooling provisions of the orders. The level of route disposition required before an exempt plant becomes regulated varies in the current orders. As recommended, any plant with route disposition during the month of 150,000 pounds or less would be exempt in the consolidated orders. This limit reflects the maximum amount of fluid milk products allowed by an exempt plant in any current Federal milk order and ensures plants that are currently exempt from regulation would remain so. (63 FR 4818)”

This decision confirmed the existing 150,000 pound size-based exemption in the West Texas-New Mexico order (7 CFR 1138.8(e)). This limit was set in 1991, based on proponent testimony. (56 Fed. Reg. 42246) That decision concluded that 150,000 pounds, which was

smaller than the size of the average producer in the market, was small enough not to disrupt orderly marketing.

“It is noted that the 150,000-pound monthly size limitation for an exempt plant is substantially less than the average size of producers that are currently associated with these markets. Consequently, it would appear that a plant of such size would not be a disruptive factor in the market either in terms of sales of fluid milk products or in the procurement of raw milk supplies. (56 FR 42246)”

2. Setting the Size Limit

Based on changed conditions, NMPF proposes to raise this limit to 450,000 pounds, consistent with the principles upon which the 1991 decision was made. Between 1991, the year of the West Texas-New Mexico hearing and decision, and 2007, the last year for which data is available, average milk production per U.S. dairy farm tripled from 68,000 pounds to 214,814 pounds. Since the original 150,000 pound limit was based in part on a consideration of farm sizes at that time, this tripling of average per-farm production supports a tripling of the exemption limit to 450,000.

Fluid milk bottling plants generally have increasing economies of scale. That is, the bigger they are, the lower their costs per gallon. This has been consistently demonstrated in industry and academic studies. These economies of scale flatten out, so that the advantages of increasing plant size are greater at the bottom of the range than at the top. Several published studies, including two studies at the University of Maine and a nationwide study conducted by Cornell University, all clearly demonstrate this principle. (Exh. 23, pp. 10, 21).

Although exempt plants enjoy the same price advantage that producer-handlers now do, for very small plants this advantage is greatly outweighed by high processing costs; so that the

price advantage is neither the primary basis for a small handler's business nor a disruptive force on the market. Given this cost structure, such a plant should have little impact on the market, and so its regulation is not necessary to maintain conditions of orderly marketing. That is, such plants will not proliferate on the basis of their regulatory cost advantage.

NMPF recognizes the difficulty of setting any "bright line" size limit. Nevertheless, there remain several good reasons for setting the limit at 450,000 pounds.

It is clear that the current limit is too low. A plant processing the output of a 90-cow dairy cannot compete in the milk commodity market. If the current limit is too low, then raising it incrementally is a positive improvement in the regulation. As a matter of principle, the change should be cautious, increasing to a level that is clearly not too high.

This proposal addresses the regulatory status of milk plants with respect to size, and does not attempt to effect any regulation of dairy farms. However, milk plants obtain their milk from dairy farms, whether they are under the same ownership or not. Farm size has served in the past as a basis for establishing a size limit on exempt plants. In addition, a very large share of the size-exempt plants bottle own-farm production, strongly suggesting that farm bottling is the primary business model for these plants, so that farm size and farm economies of scale must be an important consideration in defining their regulation.

Dairy farms have economies of scale such that there are cost disadvantages to a producer-handler with less than 500,000 pounds of monthly production. This is the conclusion of a USDA study of farm size. In 2005, it was estimated, farms with 500 to 999 cows had a \$4.75 per hundredweight cost advantage over farms with 100 to 199. This is a difference of 41¢ per gallon,

and represents a substantial scale economy. In addition, this study showed that 500,000 pounds per month of production (about 300 cows) is near the point where the cost curve begins to get quite steep. That is, below that size, farm cost of production is clearly high enough that the value of the regulatory exemption will not encourage uneconomic processing paired with production. Based on this data also, 450,000 pounds represents a reasonable bright line limit on regulation of an integrated farm and plant, which is one common business model for small exempt plants. (McDonald, James, et al., *Profits, costs, and the changing structure of dairy farming*. Economic Research Report No. 47; USDA/ERS; Sept. 2007. p. 9, cited in Exh. 23.)

Under the mandates of the Regulatory Flexibility Act of 1980 and the Small Business Regulatory Enforcement Fairness Act of 1996, Federal agencies must consider impacts of regulation on small business. The formal small business definition for dairy farms is \$750,000 in sales or less. (13 CFR 121.201) As a practical matter, and because revenue fluctuates with milk prices, USDA, the Small Business Administration, and the Office of Management and Budget have determined that regulatory flexibility analysis should be based on a small business definition of 500,000 pounds of monthly milk production. (70 Fed. Reg. 74185) Given that a fluid milk handler can be hard pressed to achieve a Class I use rate of more than 90% of receipts, 450,000 pounds represents an approximate upper limit of the Class I use for a handler within this small business definition.

The small business definition was originally intended to provide a context for consideration of alternative regulatory approaches for smaller businesses, rather than serving as the basis for exemption from meaningful or necessary regulation. Nevertheless, Federal small business definitions are used in a number of programs, such as Federal procurement programs,

where a bright line is necessary and where the limit provides one reasonable choice. (Examples may be found at 7 CFR 4280.103, 7 CFR 4290.50, 12 CFR 24.2, and 13 CFR 127.) The small plant exemption in Federal orders was originally intended to alleviate the administrative and regulatory burden of regulating small entities. This intention was consistent with the objectives of the Regulatory Flexibility Act of 1980 and Small Business Regulatory Enforcement Fairness Act of 1996. Those acts recognize that regulation designed with large enterprises in mind can be unfairly burdensome when applied to small businesses, and require consideration of the impacts. Combined with consideration of economies of scale, above, the small business definition for a dairy farm provides a reasonable bright line for the exempt plant definition. The small business definition for dairy plants, by contrast, is 500 employees; such a plant would be very large, and well beyond any reasonable limit for the regulatory exemption under discussion.

Finally, the limit should be set at the same level in all markets, consistent with the decision made at order reform. This should preclude setting the limit in each market according to a proportional impact on the individual market. The market-by-market approach should also be avoided because the larger consideration is whether a proliferation of exempt plants is probable and whether that proliferation could cause disorderly marketing, rather than what the impact of an individual handler may be.

3. Clarifying the exempt definition as based on total plant sales

Finally, NMPF proposes a change in the wording of the size-based exemption, to make clear that the expanded 450,000-pound monthly allowance applies to a plant's total sales, not only to sales in an individual market. This would avoid confusion and would confirm the current

interpretation that is applied by the Market Administrators.

This principle should be applied to any decision resulting from this proceeding. That is, any size-based limit on fluid sales should be applied to a plant's total fluid sales, not only sales in a particular market.

4. Unique Labeling

NMPF further proposes that an exempt plant should not produce any products under brands that are also produced by other plants. Clearly associating an exempt plant's products with a plant-specific brand or brands will enforce the plant's independent nature. This is intended to reduce the potential for the assembly of a supply of packaged milk by a cost-oriented milk "integrator" with substantial control of the exempt plant's product. Without such a limitation, a large retailer could recruit small exempt plants, organizing production in such a way as to remove the diseconomies of scale in marketing and distribution and even, through line specialization, of processing. Such an "integrator" arrangement would violate the intent and spirit of the size-based exemption, which is intended to accommodate small businesses that are unlikely to affect their market, either individually or collectively. This qualification of exemption should be included in any decision arising from this hearing.

E. Proposal 26: Providing a Conditional Exemption for Existing Producer-Handlers

NMPF submitted an additional proposal that all Federal milk marketing orders be amended to provide a conditional "grandfather" exemption from pooling for current producer-handlers, up to 3 million pounds per month.

This language would allow current producer-handlers to obtain a qualified exempt plant

status. Route disposition and sales of packaged fluid milk products by such plants may be no more than 3,000,000 pounds per month, and most of the current conditions for producer-handlers must be met. In addition, the provisions are tightened to prohibit ownership of other farms or other distributing plants by the owner of a plant exempted under this proposal. This may also require conforming language similar to that now used to classify receipts of, and from, producer-handlers.

Regulatory risk is a part of doing business, and NMPF asserts that USDA has a clear right to regulate any and all distributing plants, provided that such regulation meets the objectives of the Federal orders. NMPF asserts that it is crucial to regulate all producer-handlers distributing more than 3,000,000 pounds of fluid milk products per month and to stem the proliferation of producer-handlers marketing between 450,000 and 3,000,000 pounds per month. NMPF proposes to implement this proposal simultaneously with the previously proposed elimination of the producer-handler provision. These provisions would temper the impact of NMPF's previous proposal by reducing the regulatory impact on 10 to 15 producer-handlers with between 450,000 and 3,000,000 pounds of packaged fluid milk sales per month, and whose businesses have relied in part upon the current regulations.

The record supports a "grandfather" exemption that would allow current producer-handler plants to obtain a qualified exempt plant status, provided that route disposition and sales of packaged fluid milk products by such plants is no more than 3,000,000 pounds per month, and most of the current conditions for producer-handlers are met. This grandfathered exemption would be tied to the plant, not the firm. Further tightening these conditions to prohibit common ownership with other farms or distributing plants, and common product labels, would help to

enforce the independent nature of such an exempted plant and avoid the “integrator” model discussed above. This “grandfathering” would reduce the regulatory impact on some 10 to 15 producer-handlers with between 450,000 and 3,000,000 pounds of monthly fluid milk sales; this is a reasonable accommodation a limited number of plants who have relied upon the current regulatory regime but whose individual impact, given the conditions of their continued exemption, would be small. By contrast, the larger producer-handlers have both a larger impact on the market and a greater expectation of being able to operate profitably under full regulation, based on economies of scale. (Exh. 20; Cryan, TR. 1881-1883, 1930-1931))⁶

There are several bases for the 3 million pound limit on the grandfathering of the producer-handlers. (Transcript, pp. 1909.) This is the limit applied to the fluid milk promotion program. (CFR reference) Three million pounds is also the limit applied in the current Arizona and Pacific Northwest Federal Orders (CFR reference). Allowing up to 3 million pounds for existing producer-handlers could avoid repeating a severe regulatory disruption for those plants continuing to operate as producer-handlers in those markets; and applying the same 3 million pound limit in all markets produces a uniform standard, based on the potential impact of a proliferating business model, rather than the effect of a single plant on an individual market.

Adoption of Proposal 26 remains fully consistent with Proposals 1 and 2. Again, the dual objectives of that petition are to 1) limit the disruptive impact of existing producer-handlers above 3 million pounds and 2) prevent the disruptive impact of a proliferation of new producer-handlers, with sales above 450,000 pounds per month. Allowing existing producer-handlers to maintain an exemption up to 3 million pounds per month will allow these objectives to be

⁶ Grandfathering is not without precedent in Federal orders, and certainly not in Federal regulation. This is addressed in Section V.

achieved without undue regulatory impact on these smaller existing operations.

F. Joint Considerations for Proposals 1, 2, and 26

At Arizona-Pacific Northwest hearing, scope was already defined, as between regulating producer-handlers with more than 3 million pounds of sales or not regulating them. NMPF supported regulation at that hearing. (TR. 1957-1958) NMPF's current position is consistent with that, in that NMPF continues to assert that it is important to regulated existing producer-handlers with more than 3 million pounds of fluid milk sales per month; but in addition NMPF wishes to avoid a potential proliferation of new producer-handlers with monthly sales between 450,000 and 3 million pounds, and wish to further simplify the exemption for handlers with less than 450,000 pounds.

The hearing record shows very clearly that the largest producer-handlers have come to dominate this segment of the market in a way that could not have been anticipated in any way when the producer-handler provisions were born.

NMPF reemphasizes its concern about a potential business model that might exploit a producer-handler exemption at levels between 450,000 pounds per month and 3 million pounds per month. This is the integrator model, which is now nearly universal in the poultry industry and becoming dominant in the swine industry. Under this model, an "integrator" firm could organize the production, including processing, of a string of "producer-handlers" with production just below 3 million pounds per month (production from nearly 2000 cows). There was testimony at this hearing about the interest expressed by large retailers to exploit the producer-handler pricing and pooling exemptions in order to obtain a lower price for bottled milk, even in a limited number of stores. (Lee, TR. 947; Krueger, TR. 1358-1359; Carrejo TR. 1448-1453; Wernet, TR. 2310; Wilcox, TR. 1300) There is clear potential for large retailers to exploit these

exemptions as dairy integrators, undermining Class I sales in the pool and leading to disorderly marketing and a rush to producer-handler re-organization.

The proposed labeling and common ownership limitations are especially crucial for any exemption that does not preclude proliferation. In the absence of a grandfather limitation, these are vital to avoid the potential proliferation of producer-handlers operating in “integrator” chains, which would circumvent the basic intent of these proposals, which is to avoid exempting large bottling operations organized primarily to exploit such an exemption.

The labeling restriction NMPF proposes would allow an exempt plant to produce under any number of labels it chooses, provided none of these are shared with any other plant. (TR. pp. 1892-1893) NMPF urges the adoption of this language, and further urges that this intent be made clear in USDA’s decision findings. This would retard the use of multiple exempt handlers to provide commodity products to large wholesalers or retailers whose procurement is based primarily upon price, since the proliferation of such exemption-based price competition would disorder markets through leaking out of milk from the marketwide pool, and resulting disparities in pay price.

Several witnesses described the types of abuses that this language is intended to prevent. Several of the IDFA witnesses outlined the disadvantage they faced when “sharing a (customer’s) label” with an existing producer handler. They testified that orders from such customers were more variable, because the pooled handler was balancing the supply of the producer handler through the retailer. (Wernet, TR. 2328, et seq.; Krueger, TR. 1384-1386)

NMPF asks that USDA draft the final language to be strict enough that labels that are so subtly different that they are intended appear the same to consumers should not be considered

unique.

The common ownership limitation avoids firms' reorganizing to avoid the size limits on exempt plants. There is precedent for this in several orders, including the Pacific Northwest Order, under which a producer-handler may be "neither directly nor indirectly associated with the business control or management of, nor has a financial interest in, another handler's operation; nor is any other handler so associated with the producer-handler's operation."

(7CFR1131.10(a)(4))

Adopting all three proposals on a national basis is appropriate. Large producer-handlers are having an impact on all 10 Federal order markets. For example, the national sales of Aurora Dairy, a single producer-handler whose national sales are equal to about 17% of the organic milk market in the U.S. (Arnold, TR. 1759; Keefe, TR. 2908; USDA Dairy Market News, March 20, 2009, p. 12) More importantly, large producer-handlers have the potential to impact all Federal order markets through the continued growth of such handlers. NMPF has long advocated for regulation that addresses potential problems prospectively, especially when they have already disordered other markets. In this case particularly, removing the producer-handler exemption will stop investment predicated on a regulatory loophole, and promote investment based upon full participation in the Federal order system. The national reform of these provisions will also avoid a series of redundant hearings. Nationally consistent provisions will also simplify administration for the market administrators and clarify the rules for handlers.

There is no basis for treating niche marketers of fluid milk products differently from other fluid processors. Exempting producer-handlers because they serve "niche" markets and so face higher costs, is unprecedented. The record does not identify any general benefit of such niche

marketers beyond their benefits to their customers. If these niche products have a higher cost, then their customers can, will, and must bear them, over and above their equitable contribution to the Federal order pool. (Knutson, TR. 3045, et al.; Kreider, TR. 2633, et seq.) In addition, these “niche” products are generally recognized as competing with conventional milk on the margin for both supply and demand, and so affect the general market for milk.

G. Expected Impacts of Proposals 1, 2, and 26

The testimony of several of these large handlers made it clear that their businesses would not be fundamentally undermined by full regulation. The witness from Braum’s Dairy questioned whether they would even contribute to the producer settlement fund, based on their blend of utilization. (Bostwick, TR. 2841) Mr. Hettinga indicated that he expected to grow his business and eventually abandon producer-handler status, in any case. (Hettinga, TR. 2723, et seq.) The witness from Heartland Dairy pointed out they had operated as a pool plant in the past, indicating/implying that they could do so again. (Button, TR. 3600)

By contrast, many of the smaller producer-handlers had concluded that full regulation would jeopardize their business. NMPF asserts that the limited individual impact of bottlers with less than 450,000 pounds of monthly fluid milk sales, and a cost structure that leaves them as a commodity price disadvantage to the average pool distributing plant, justifies their exemption from regulation. This would accommodate some 20 to 25 current producer-handlers, whose size would tend to prevent them from competing with processors of the most common forms and packages of fluid milk.

Many of the producer-handlers that testified against Proposal 1 would obtain regulatory relief by means of Proposals 2, and 26. A small number would become fully regulated, given

their current size and structure.

Among the larger producer-handlers, 5 appear to be subject to full regulation.

A few handlers who have relied upon the producer-handler provisions may be adversely affected by these proposals. However, regulatory risk is widely understood to be inherent in a regulated business like the dairy industry. Federal order reform changed the rules and so changed marketing conditions for many producers and processors. The risk of increased regulation of producer handlers has been clear, at least since the beginning of hearings for the Arizona and Pacific Northwest milk markets in 2003. Even Dr. Knutson, an opponent of increased regulation for producer-handlers, recognized that the risk of increased regulation is present and may have limited the expansion of large producer-handlers. (Knutson, TR. 3220-3221) Another witness testified to his reluctance to adopt producer-handler status out of concern that the market impact of a large producer-handler would attract attention and provoke a change in the regulation. In this connection, it should also be pointed out that at least three of the five producer-handlers most likely to be affected by the proposed changes made some of their largest investments after the hearing was called to consider limitations on producer-handlers in the Pacific Northwest and Arizona markets. GH Dairy, Aurora Dairy, and Heartland Dairy all invested in new plants built after that hearing had demonstrated the clear regulatory risk of relying upon the producer-handler exemption. Braum's moved in and out of full regulation until shortly before that hearing, as well, and its manager testified that it might not owe an obligation to the pool, if regulated.

All but the largest 5 producer-handlers that testified at the hearing, would receive regulatory relief from Proposal 1 by means of Proposals 2 and 26.

H. Small Business Impacts

None of the handlers that would face increased regulation are small businesses, based on the definition of a small business dairy farm.

By contrast, tens of thousands of small business dairy farms and dairy processors who participate in Federal order pools would benefit from more orderly marketing and a reduced threat to the integrity of the Federal order producer pools.

I. Comments on other Proposals

Most of the proposals in this hearing advocate or assume limits on the exemption of producer-handlers. In this sense, most of the participants here agree that it is appropriate to fully regulate very large producer-handlers, and to make some accommodation for very small plants.

Several of the additional proposals reiterate, in whole or in part, Proposals 1 and 2, as offered by NMPF and IDFA. These include Proposals 10, 16, 19, and 22. NMPF appreciates this support from Way-Har Farms, Coopers' Hilltop Farm, the Pennsylvania Association of Milk Dealers, and the Northeast Dairy Foods Association. (74 FR 16296, et seq.)

NMPF opposes the rest of the additional proposals, while appreciating that some have been offered in a spirit similar to that of NMPF's proposals.

Proposals 3, 4, 5, 7, 8, 11, 13, 15, 18, 21, 27, and 28 each set a cap for producer-handlers and allow their unlimited proliferation. Each of these is a step in the right direction, but does not go far enough in addressing the potential of a proliferation of medium-sized producer-handlers to disorder milk markets. Although NMPF appreciates the support from these proponents for the principle of limiting the impact of producer-handlers on milk markets, the arguments above make clear above why the producer-handler status should not be extended to any additional plants. (74

Fed. Reg. 16296, et seq.)

J. NMPF Opposes Proposal 13, 17, 20, and 23

NMPF opposes any soft cap proposal. Proposals 13, 17, and 20 would establish a “soft” cap of 3 million pounds of fluid milk sales per month for producer-handlers. They would allow any handler that had both fluid milk sales and own-farm production during an historical period to elect to exempt up to 3.41 million pounds of that historical own-farm production, whether or not they had ever qualified as a producer-handler. (74 Fed. Reg. 16300-16303) This would allow much larger plants to exploit a pricing exemption on up to 3 million pounds; this is similar to the exemption that several producer-handlers have under the California price and pooling system. Dr. Schiek, from the Dairy Institute of California testified in some detail regarding the hardship that this places on the pooled participants of the California system. He showed how the five exempted producer-handlers steadily gained market share in California on the basis of a substantial pricing advantage. These five plants had average fluid milk sales of more than 24 million pounds per month, including an average of more than 4 million pounds of exempted Class I milk each, for which they had a pricing advantage comparable to that now enjoyed by producer-handlers in the Federal order system. Dr. Schiek explained how this pricing advantage allows these large bottlers to undercut prices for pooled participants, leading to price disparities and disorderly marketing. (Exh. 75, pp. 2, 6, 7)

A soft cap would similarly disorder Federal order markets, so that any such proposal, including Proposals 13, 17, and 20 should be denied.

The effect of Proposal 23 would be to establish an unlimited soft exemption for producer-handlers, by allowing them to be exclude all their own-farm milk from the pool. This is a

substantial loosening of the current producer-handler restrictions, it does nothing to address the current disorderly marketing conditions associated with producer-handlers, and NMPF opposes it.

K. NMPF Opposes Proposal 24

Proposal No. 24 would exempt milk sold directly from producer to retail customer, including through home delivery and handler-controlled retail outlets. NMPF opposes special producer-handler exemptions for home delivery or retail integration. Today, home delivery is a small niche market, but one that can compete with the mainstream milk markets when they receive a price break as large as that now allowed to producer-handlers. This can be seen in the growth of Internet-based retailing, including the general grocery home delivery business entered by several large grocers; this business is not based on regular deliveries of two quarts a day, but on individual orders made online and responsive to variable prices. (74 Fed. Reg. 16308-16310)

As described above, even handlers who sell directly to the consumer cannot be forced to completely balance their own part of the market. Plants that own retail stores can stock other handlers' milk alongside their own, forcing the burden of balancing upon the rest of the market. Even plants that sell only their own milk, through their own retail stores or home delivery, can adjust their pricing and sales efforts seasonally so as to indirectly encourage consumers to rely on other milk outlets when the plant-retailer's supply is short; this also forces the balancing burden onto the rest of the market.

It was also clearly demonstrated by the testimony of several witnesses that both retailers and home delivery dairies can ultimately offer their customers pricing incentives to balance supplies through other retailers. (Kruger, Mallorie's, Lee, Bareman, Country Dairy, TR. XXX)

The exemption of farm-to-retailer sales in this proposal does not avoid the handler placing a balancing burden on the rest of the market; it is inequitable and so should be denied.

L. NMPF Opposes Proposal 25

Proposal No. 25 would establish “individual handler” pools for all handlers across all orders. This is especially pernicious proposal is a dagger pointed at the heart of Federal orders. Just as NMPF opposes the continued exemption of large producer-handlers as anathema to orderly marketing, so NMPF opposes Proposal 25. These would give every handler the exemption from pooling that producer-handlers now have. Individual handler pooling would reward those handlers who cherry-pick Class I markets while making the least contribution to balancing their markets, and punish those handlers that make the greatest contribution. The elimination of marketwide pooling would lead, as described above, to price disparities that would badly disorder milk marketing. It is very near to deregulation, an outcome preferred by numerous advocates for individual handler pooling. (74 Fed. Reg. 16310-16318)

Individual handlers pools represent cherry-picking of higher Class I values. Because the plants and cooperatives that effectively balance the fluid milk supply do not receive equalization payments from the pool, they will be unable, in many markets, to maintain the manufacturing capacity that is necessary to balancing. Because the suppliers of fluid milk plants receive a higher price, competition for Class I outlets will destroy producer over-order premiums, further undermining the compensation now paid for market balancing. Market-wide pooling of classified prices is the single most important function of the Federal milk marketing order: with individual handlers pools, the orders would be fatally wounded, and producer losses would be multiples of the losses associated with producer-handlers.

The 1999 final decision on Federal order reform concluded that:

“Marketwide sharing of the classified use value of milk among all producers in a market is one of the most important features of a Federal milk marketing order. It ensures that all producers supplying handlers in a marketing area receive the same uniform price for their milk, regardless of how their milk is used. This method of pooling is widely supported by the dairy industry and has been universally adopted for the 11 consolidated orders.” 64 Fed. Reg. 16130 (April 2, 1999)

It seems beyond question that individual handler pools are inimical to modern Federal orders.

M. Mallorie’s Proposal

A final hybrid proposal, offered by the witness for Mallorie’s Dairy, offers an interesting alternative to NMPF’s proposals. It would adopt a soft cap of 2 million pounds together with a hard cap of 6 million pounds. Such an approach, with the soft cap reduced to 450,000 pounds and the hard cap set at 3 million pounds, would accomplish some of NMPF’s objectives.

However, it could continue to encourage the proliferation of producer-handlers in the middle size range, with the attendant threat to orderly marketing; and would it impose considerable new regulation on the existing handlers in that range. NMPF must therefore oppose this proposal as inadequate to the objective of orderly marketing. (Flanagan, TR. 2517)

N. Conclusions

The current producer-handler provisions have become outmoded by a changing industry, and NMPF asserts that their underlying intent of limiting the regulatory burden of small handlers who do not substantially impact the market is better served through an expansion of the exempt handler provision. Based on the demonstrated disorder caused by existing large producer-handlers, the clear potential for continued growth in the numbers and volume of large producer-

handlers, but considering the trade-offs between regulatory burden and regulatory benefits, NMPF urges USDA to eliminate the general producer-handler provisions. NMPF also asks USDA to temper this change with a modest increase in the size-based plant exemption and with a “grandfathering” of smaller existing producer-handlers, in order to avoid imposing an undue regulatory burden on small business that have limited impact on their markets, but whose proliferation could lead to disorderly marketing.

NMPF urges USDA to implement Proposals 1, 2, and 26 in their entirety.

V. LEGAL ARGUMENT/DISCUSSION OF LEGAL ISSUES RAISED OR PRESENTED

A. 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 are so firmly established, that arguments made here by the producer-handlers are legally frivolous. This is confirmed by an analysis of the AMAA's statutory language, the legislative history preceding its adoption and judicial decisions which address and define the authority granted to the Secretary by the AMAA.

1. The Statutory Language

An analysis of the language of the several sections of AMAA discloses a single, salient, irrefutable fact relating to the issue presented by proponents' proposal to limit the producer-handler exemption: the AMAA, by its terms, does not grant to the Secretary authority to exempt from pricing and pooling under a milk order the milk of a producer acting as a handler of his own milk production. As the Secretary's Judicial Officer explained in *Independent Milk*

Distributors Association, 20 A.D. 1,29 (1961), producer handlers "have no legal right to be exempt from regulation."

A review of the AMAA's several sections clearly supports that conclusion. The basic mechanism for achieving the "orderly marketing" policy objectives declared by Congress in Section 2(1) of the AMAA is through the statutory authority granted to the Secretary to regulate "handlers" by requiring them to pay minimum "uniform prices" for milk purchased from producers. The term "handler" is defined in Section 8c(1) to include "processors, associations of producers, and others engaged in the handling of any agricultural commodity or product thereof."

Under Section 8c(5)(A), the Secretary is authorized to fix minimum class prices for milk "which all handlers shall pay...for milk purchased from producers or associations of producers.

Such prices shall be uniform as to all handlers subject only to [specified] adjustments . . . "

While Section 8c(13)(B) of the AMAA precludes the Secretary from issuing a milk order "applicable to any producer in his capacity as a producer," there is nothing in the Act that purports to exempt a producer "in his capacity as a [handler]" from the full regulatory coverage of the Secretary's milk orders. To the contrary, the AMAA expressly contemplates complete regulatory coverage of producers in their capacity as handlers by providing in Section 8c(5)(C) that in order to insure the uniformity of class prices among handlers and producers mandated by Sections 8c(5)(A) and (B), the Secretary shall provide in each order:

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.

Counsel for AIDA, and their witnesses, have sometimes cited the words "milk purchased"

in an effort to avoid the clear intent of the statutory provision, totally ignoring the settled law which not only authorizes, but directs, the Secretary to require the pricing and pooling of milk of "producers who are also handlers."

2. The Authority Of The Secretary To Regulate Producers Who Are Also Handlers Has Been Settled Law For Decades

Judicial decisions and prior adjudicatory decisions of the Secretary have confirmed the Secretary's authority to fully regulate producers with respect to their own farm production which they market as handlers. *United States v. Rock Royal Cooperative*, 307 U.S. 533, 579-580 (1939) ("the word 'purchased' [in 8c(5)(C)] means 'acquired for marketing'"); *Freeman v. Vance*, 319 F.2d 851 (5th Cir. 1963), cert. denied, 377 U.S. 930 (1964); *Ideal Farms, Inc. v. Benson*, 288 F.2d 608 (3rd Cir. 1961, cert. denied, 372 U.S. 965 (1963); *Acme Breweries v. Brannan*, 109 F.Supp. 116 (N.D. Cal. 1952). In *Acme Breweries*, the court held that the Secretary was authorized under the AMAA to regulate a brewer who processed in the brewing of beer all of the hops which he grew because "the Act authorized the Secretary to apply orders regulating the handling of [agricultural commodities] to "processors, associations of producers, and others engaged in the handling of [the commodity]." 109 F. Supp at 117. The court noted further that:

The Act exempts two classes of persons from regulation: "any person who sells agricultural commodities ... at retail in his capacity as such retailer," 7 U.S.C.A. Sec. 608c(13)(A); and "any producer in his capacity as a producer." 7 U.S.C.A. Sec. 608c(13)(B). The inclusion of these exemptions in the Act indicates that it was intended that the incidence of regulation should fall upon those who do something with . . . hops other than to grow them or to sell them at retail. The language "in his capacity as . . ." limits the exemption in each instance. *Id* at 18. The court concluded that "[t]he declared policy of Congress can be achieved only if all hops which supply the commercial demand therefore are regulated." *Id.* at 120.

In *Ideal Farms, Inc. v. Benson*, supra, the Third Circuit upheld the Secretary's authority under the AMAA to compel a handler to account to the federal order pool for milk which the handler produced on his own farm and bottled and sold in competition with other regulated handlers. In rejecting the appellants' contention that AMAA did not authorize the Secretary to regulate producers in their capacity as handlers, the Third Circuit said:

Were we to accept appellants' construction...they could 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. See *United States Rock Royal Cooperative, Inc.* supra . . .

288 F. 2d at 613. Noting that Sec. 8c(5)(C) of the AMAA authorizes the Secretary to regulate "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 [by the order]) (id. at 614), the court concluded that "[t]he more reasonable construction [of the section] is that the parenthetical phrase was meant to reach a producer-handler who handles or distributes milk which he himself produces." Id. at 615. Accord, *Freeman v. Vance*, supra. ("the AMAA applies to a producer in his capacity as a handler").

The Secretary has never questioned the validity of the foregoing judicial decisions but has, in fact, acknowledged their controlling effect in the administration of the milk order program under AMAA. See *In re John Bertovich et.al.*, 36 A.D.133(1977). As the Judicial Officer, who speaks for the Secretary, explained (quoting *In re Associated Milk Producers*, 33 A.D. 976, 992 993 (1974): "It is settled that the Secretary is authorized by the Act to fully regulate "producer-handlers" even if they receive no milk from anyone else....The Secretary is not required to provide any exception for "producer-handlers."

The legislative history of the AMAA further confirms this authority. In 1935 Congress re-enacted the sections of the Agricultural Adjustment Act of 1933 by the Act of August 24, 1935, 49 Stat.750. The provisions for regulating producers who were also handlers were discussed in hearings in 1935 on H.R. 5585 before the Committee on Agriculture, House of Representatives. During the House hearings, considerable discussion focused on Sections 608c(5)(C) and 608c(13)(B)("No license ... shall be applicable to any producer in his capacity as producer") because of concern by Committee members that nothing in the bill should impose any limitation on producers. Responding, Chester C. Davis, Administrator, Agricultural Adjustment Administration, explained that producers who were also handlers could be regulated, not as producers, but in their capacity as handlers and processors. He testified:

No matter what anyone has said or may say, licensing of producers is definitely not contemplated...except the licensing of a producer acting in the same capacity as a commercial enterprise; that is, where a producer also is a large distributor or engages in business in such volume that his cooperation is necessary to carry out the plan; in that case he would be licensed, not as a producer but as to his capacity as a handler and processor.

Hearings on H.R.5585, 74th Cong., 1st Session at 14.

When the bill reached the Senate, the same intention was confirmed in the following colloquy which occurred on July 15, 1935:

Mr. Copeland: In upstate New York a great many of the milk handlers are producers and distributors. According to the amendments as they are set up, if I am correctly advised, everyone of those who may directly... affect interstate commerce would be subject to all the orders promulgated by the Secretary of Agriculture. These producers and distributors would be required to make adjustments in payments by being compelled to contribute to the maintenance of an adjustment or equalization fund and to pay their pro-rata share of the expenses to the authority or agency which administers the order. Therefore, the distributors who have

an additional investment in not only producing their own milk, but also in pasteurizing the milk...would have to share their position in the market with other producers. Is that correct?

Mr. Murphy: Yes; that is correct.

(79 Cong. Record 11138 (1935).) It was further explained by Senator Byrd later during debates on the floor of the Senate: "if a producer handles his own milk, he becomes a handler and therefore is subject to all the rules and regulations affecting handlers." 79 Congo Rec.11140 (1935). Thus, as is plainly revealed by the foregoing review of the legislative history and excerpts of the debates on the bill that became the Agriculture Act of 1935, reenacted as the AMAA of 1937, it was contemplated by the Congress that enacted Section 608c(5)(C) of AMAA that "producer-handlers" could be regulated in the same manner and to the same extent as the AMAA regulates other handlers.

3. Congress Has Not Changed The Legal Status Of Producer-Handlers Under AMAA Through Amendments Adopted Over the Years Mentioning Producer-Handlers.

It has been argued by producer-handlers that language in the Food and Agricultural Act of 1965, and similar language in later enactments, changed the status of producer-handlers under the AMAA.⁷ This contention is plainly erroneous. Section104 of the 1965 Act contained the following language:

The legal status of producer-handlers ... under the [AMAA] shall be the same subsequent to the adoption of the amendments made by this title as it was prior thereto.

⁷ The Department unnecessarily provided fuel to this contention when, in the 1999 Proposed Rule on Federal order reform it was stated, erroneously "[S]ince 1965, the legislation has consistently and specifically exempted producer handlers from regulation." (64 Fed. Reg. 16135)

The fundamental problem with reliance on the 1965 and subsequent legislative enactments to legitimize the producer handler-exemption is that it misreads and misinterprets the legal significance of those enactments. When the 1965 legislation was in the House, an amendment from the floor that would have made the exemption of producer-handlers mandatory. The amendment was rejected. (Cong. Rec., August 18, 1965 p. 20142). Furthermore, the House Report on Section 104 of the 1965 Act, relating to producer-handlers, expressly disavowed approval of special status for producer-handlers, stating:

[We] disapprove of special treatment... for those producer-handlers who, singly or in the aggregate, have a volume of sales which represents a substantial enough portion of the sales in a federally Ordered market to substantially disrupt the operation of the Order to the detriment of other dairymen in that Market.

(House Report No. 631, July 20, 1965 to Accompany H.R. 9811)

The Departments's contemporaneous understanding of the 1965 Act was set out in a 1966 rulemaking decision where a group of producer-handlers moved to exclude from the hearing proposals that had the effect of materially changing the status of producer-handlers under the Order, claiming that such proposals were precluded by Section 104 of the 1965 Act. The Secretary flatly rejected that contention stating:

Section 104 [of the 1965 Act] did not purport to change the previous law but merely reaffirmed it. The language is specifically directed to reaffirming legal status under the statute, rather than under the provisions of any order that has been issued under the authority of the statute. The Congress rejected an amendment which would have specifically denied authority for regulation of producer-handlers. Thus producer-handlers who were potentially subject to regulation under the statute prior to the 1965 amendment remain potentially subject to regulation thereafter.

Decision on Proposed Amendments to Puget Sound, Washington Order, 32 F.R. 10742, 10746, July 21, 1967.

In view of the foregoing, plus all of the post-1965 decisions of the Secretary's Judicial Officer confirming that "It is settled that the Secretary is authorized...to fully regulate producer-handlers," there is no basis to contend that the various Congressional enactments in 1965 and thereafter have any affect on the authority to regulate producer-handlers.

4. The Exempt Plant Provisions Fully Recognize Small Handler Businesses Which Have Little or No Effect on the Pool.

While there is no requirement in the AMAA that orders exempt from pool regulations any handlers of milk products distributing in the marketing areas, the exempt plant provisions of Proposals 1, 2, and 26 would continue and update the Department's practice of not regulating those entities whose "businesses are so small that they have little or no effect on the pool." (Decision on Proposed Amendments to New England Order, 25 F.R. 7819, 7825 (1960). This practice developed under the 1933 and 1935 legislation that preceded adoption of the AMAA of 1937, has continued over the intervening years and would continue via the exempt plant provisions under the IDFA and NMPF proposals.

The continuation and expansion of the exempt plant category de facto continues to carry forth the core of the administrative basis for the producer-handler exemption, that being that the producer-handlers exempted are "commercially insignificant factors" so as not to require pricing and pooling under milk orders. This core rationale has been articulated numerous times over the years. In *In re Jacob Tanis et.al*, 17 A.D. 1091, 1104 (1958), for example, the own farm milk exemption of the order was adopted, according to the Secretary, out of concern "for the family-farm type of operation" because: "That type of operation was not thought to be sufficiently significant to constitute a serious competitive factor in the marketing area."

In *In re Stew Leonard's*, 59 A.D. 53 (2000), the Secretary's Judicial Officer explained, as the reason for the producer-handler exemption, that: "Historically, producer-handlers were normally "family-type"operations Customarily, a producer-handler has a relatively small operation, is operating in a self-sufficient manner, and is not a major competitive factor in the market for regulated handlers." In affirming the Judicial Officer's decision in that case, the federal district court explained, further, the basis for the New England Marketing Order's producer-handler exemption: "Typically, a producer-handler conducts a small Family-type operation processing... and distributing only his own farm production. Full regulation of such individuals provides considerable administrative difficulties. Normally, exemption from regulated status is made in a Federal order for such individuals on the grounds that such businesses are so small that they have little or no effect on the pool. . ." *Stew Leonard's v. Glickman*, 199 F.R. D. 48, 55 (D. Conn. 2001) (quoting "Decision on Proposed Amendments To Tentative Marketing Agreements and to Orders," 25 Fed. Reg. 7819 (Aug. 16, 1960).

Furthermore, in the case of *In re Mil-Key Farms, Inc.*, 54 A.D. 26 (1995), the Secretary's Judicial Officer adopted the same rationale for the producer handler exemption stating: "A primary basis for exempting a producer-handler from the pricing and pooling provisions of the order is that such a person has a relatively small operation and is operating in a self sufficient manner. . . . Under this arrangement, a producer-handler seldom can be a major competitive factor in the market for regulated handlers [Quoting, in part, 53 Fed. Reg. 49154, 49159-49160 (Dec. 6, 1988)]"

Proposals 1, 2, and 26 provide for full regulation of large producer-handlers coupled with the expansion of the volume limit for the exempt plant category. These proposals are fully authorized by the AMAA and carry out the longstanding policy of federal order administration to

exempt from full regulation those entities which do not have a significant impact on the commercial market while fully regulating those entities which are factors in the commercial marketplace.

B. The Secretary Is Directed by the AMAA to “Establish and Maintain Orderly Marketing Conditions” and Prevent Potential Threats to Orderly Marketing

Congress, in the AMAA, has declared that its purpose is to “establish and maintain such orderly marketing conditions” as will achieve the objectives of the Act to further producer and consumer welfare. There is plainly both a pro-active and re-active element to this mission: orderly conditions are to be both established and maintained. Nevertheless, throughout the course of this hearing, Counsel for the producer-handlers and their witnesses sounded a theme that there was allegedly no present disorder in various markets and that proponents would be required to produce evidence of existing disorderly marketing that would warrant action by the Secretary in order to amend the existing producer-handler provisions throughout the system. Implied in these contentions is the assumption that the Secretary is powerless to act absent a present showing of market chaos or disorder.⁸

This argument discloses a basic misconception of what a 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].

⁸ This approach to regulatory policy would, for instance, require that the Metro transit system in DC experience an accident before the operators could take preventive action.

The issuance of a notice of hearing on Proposals 1-4 constitutes a two-fold determination by the Secretary that (1) the Proposals are ones that lawfully may be adopted, (2) there is “reason to believe” they 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 his regulatory powers until chaotic or disorderly marketing conditions are shown to exist in the federal order system. In *In re Independent Milk Producer-Distributors*, 20 Agric. Dec. 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 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 Fed. Reg. at 49383). The record evidence here is clear beyond dispute that the exemption of producer-handlers from the minimum pricing provisions of all federal orders threatens not only orderly marketing, but a breakdown of the order system unless capped within the limits of Proposals 1, 2, and 26. (See e.g., Cryan Exh. 23; Hollon, Exh. 104)

C. **The Longevity of Current Producer-Handler Regulations Imposed no Special Burden upon the Department in Making Needed Amendments**

Those who would take advantage of longstanding regulations frequently contend that changing such regulations requires something more of an Agency than is otherwise required for rulemaking action. This is not the case, as the Supreme Court has very recently made quite clear.

The Secretary of Agriculture is authorized, pursuant to the AMAA, to establish provisions of milk marketing orders to give effect to the intent of Congress, and to change provisions of those milk marketing orders where the Secretary determines such changes to be consistent with the AMAA and appropriate. Any action taken by the Secretary is subject to review by the courts pursuant to the provisions of the Administrative Procedures Act to ensure that changes made to existing policy have been made in a procedurally correct manner, *i.e.*, not arbitrarily or capriciously. *Vermont Yankee Nuclear Power Corp. v. Natural Resources Council, Inc.*, 435 U.S. 519, 545-49 (1978). The Supreme Court has held, however, that that judicial oversight of agency action is under a narrow standard of review; when an administrative agency makes rules, or when it changes existing rules, it is simply required to “examine the relevant data and articulate a satisfactory explanation for its action.” *Motor Vehicle Mfrs. Assn.*

of United States v. State Farm Mut. Automobile Ins. Co., 463 U.S. 29, 43 (1983).

Until just recently, the Supreme Court’s holdings in *Vermont Yankee* and *Motor Vehicles Mfrs. Assn.* had been misinterpreted by several of the federal courts of appeals as requiring an administrative agency to meet a different or heightened standard when it was making changes to already existing policy.⁹ However, the Supreme Court has now made it clear that these courts of appeals interpretations were not correct. “We find no basis in the Administrative Procedure Act or in our opinions for a requirement that all agency change be subjected to more searching review....The statute makes no distinction...between initial agency action and subsequent agency action undoing or revising that action.” *FCC v. Fox Television Stations, Inc.*, ____ U.S._____, 129 S. Ct. 1800, 1810-11 (Decided April 28, 2009). The Supreme Court explained that, so long as it is clear that the agency realizes that it is making changes to existing policies, the standard justifying agency action is essentially the same as that applicable when the agency first promulgates rules:

To be sure, the requirement that an agency provide reasoned explanation for its action would ordinarily demand that it display awareness that it is changing position. An agency may not, for example, depart from a prior policy *sub silentio* or simply disregard rules that are still on the books. See *United States v. Nixon*, 418 U.S. 683, 696 (1974). And of course, the agency must show that there are good reasons for the new policy. But it need not demonstrate to a court’s satisfaction that the reasons for the new policy are *better* than the reasons for the old one; it suffices that the new policy is permissible under the statute, that there are good reasons for it, and that the agencies *believes* it to be better.

⁹ See e.g., *New York Council, Assn. of Civilian Technicians v. FLRA*, 757 F.2d 502, 508 (2d Cir. 1985)(agency must articulate “why the original reasons...are no longer dispositive” and “why the new rule effectuates the statute as well as or better than the old rule.”); *NAACP V. FCC*, 682 F.2d 993, 998 (1982)(standard of review is “heightened somewhat” when an agency changes policy).

129 S. Ct. at 1811.

The milk order provisions for producer-handlers have been in place in most marketing areas since the inception of the federal orders. Over the years, and with federal order reform, there have from time to time been modifications to those regulations in mostly limited respects. The proposals in this hearing, however, will make major changes to the producer-handler regulations, potentially eliminating the producer-handler category altogether. What *FCC v. Fox* now makes clear is that the Secretary can, and must, decide these hearing issues on the basis of the record before him without being constrained to provide special justifications or being subject to heightened judicial review solely by virtue of the duration of the current regulatory policy.¹⁰

D. Adoption of Proposals 1, 2, and 26 Will Benefit Small Businesses, Both Producers and Handlers.

The hearing notice for this proceeding, in accordance with the Regulatory Flexibility Act, requires that the Secretary consider the impact of proposals upon small businesses so as “to ensure that, within the statutory authority of a program, the regulatory and informational requirements are tailored to the size and nature of small businesses.” In other words, the Secretary must first act within the authority conferred by the particular program involved and within that authority make appropriate efforts to recognize the interests of small businesses. Consequently, the Secretary’s first and primary obligation is to carry out the mandate of the AMAA to “establish and maintain orderly marketing conditions” in these milk markets and then to do so in a manner which recognizes the status and needs of small businesses.

¹⁰ NMPF Proposal 26 tempers the impact of regulatory changes by “grandfathering” producer-handlers recognized in the orders in 2008. Such ‘grandfathering’ is within the Secretary’s discretion in ‘drawing lines’ (see e.g. Rowe Exh. 38) and has been previously used in, for example, Order 2 which for years provided for ‘grandfathered’ pool plants, as well as standards for new plants coming into the pool. See 7 C.F.R. §§ 1002.24–28 (1996).

The overwhelming proportion, at least 95%, of dairy farmers pooled in the federal orders are small businesses.¹¹ None of the producer-handlers which would be regulated by adoption of Proposals 1, 2, and 26 are small business dairy farmers by the Secretary's definition. Some, such as Braum's, have sales from their handler enterprise into the hundreds of millions of dollars annually and are not small businesses by any criteria. Clearly, the balance of the small business equities tilts toward regulating these large producer-handlers.

Federal order marketwide pools are the bedrock for the stability of small business dairy farmers, and their families, from coast to coast. It is solely through the mechanism of the federal order marketwide pools that small family dairy farms throughout the country can be assured of a pro-rata share of the proceeds of a Class I marketplace. The point could not have been better stated than it was by the spokesperson for the States of Wisconsin, New York, New Hampshire, Vermont, and Pennsylvania, who testified on behalf of the more than 20,000¹² thousand dairy farms in those states, representing nearly 38% of milk in the system in 2006:

We do understand that the marketwide pooling is very important to all of our dairy farmers. They're crucial to our economies, the dairy, in all of our five states.

The marketwide pool assures that all producers, large and small, no matter where located, receive an equitable portion of the Class I proceeds of the sale of milk. Marketwide pooling is specially important for smaller producers who, on their own, have limited ability to access the Class I market.

The largest producers will take care of themselves. The Federal Order pools look out for all producers. The Federal Order

¹¹ "Producer Structure in Federal Milk Orders in May 2005", AMS, USDA.

¹² Wisconsin, New York, and Pennsylvania are ranked 1, 2, and 3 respectively as supplying states to the federal order system. The five states together supplied just less than 38% of milk to the system in 2006 (FMOS Annual summary 2006; Sources of Milk for 2006, AMS, Dairy Programs). In 2006 there were 52,725 producers on average supplying federal orders.

marketwide pools are a classic case of the greatest good for the greatest number.

Unlimited exemptions will doom pooling. The marketwide pools will not and cannot survive with unlimited exemptions from pooling. Continuation of an unlimited producer-handler exemption will ultimately destroy the Federal Order marketwide pools because it erodes the twin foundations of equal handler minimum prices and equal sharing by producers of Class I proceeds.

Bothfeld, Tr. 1089–90.

In addition to the benefit to small producers, adoption of Proposal 2, increasing the exempt plant limit threefold to 450,000 pounds of Class I distribution per month, will lighten the regulatory burden on a substantial number of handlers of various types, both small producer-handlers and small proprietary handlers. For handlers, as well as producers, the net impact of adoption of Proposals 1, 2, and 26 is a benefit to small business which the Secretary should not overlook.

In summary, any attempt by the AIDA group to cloak themselves in the garb of small producers, or use small producer-handlers or exempt plants as a shield to preserve their ability to undermine federal order pools, should be rejected as being the proverbial ‘wolf in sheep’s clothing.’ The federal order marketwide pools operate for the benefit of small dairy farmers and the pools need to be preserved by adoption of Proposals 1, 2, and 26. In addition, the increase in the size limit for exempt plants will ease the regulatory burden on numerous small handlers of various types throughout the system. The Secretary will fulfill his obligations under the Regulatory Flexibility Act with respect to both producers and handlers by adopting proposals 1, 2, and 26.

E. USDA Acceptance of the National Milk Proposals is not Precluded in Any Way by the Milk Regulatory Equity Act.

The Secretary of Agriculture has historically had the authority under the AMAA to regulate Producer-Handlers, including the authority to define which producers qualify for that status. The Secretary has also had the authority to determine which plants could be exempted from full regulation.

In 2005, Congress made two limited amendments to the AMAA when it passed the Milk Regulatory Equity Act. The MREA was a very short piece of legislation – only two pages long. With respect to the issue of Producer-Handlers, the MREA contains two subsections, (M) and (N), that were intended to address producer-handler issues in certain circumstances, and a third subsection, (O), that made it clear that, otherwise, the existing law with respect to Producer-Handlers was not changed.

First, in subsection (M), Congress clarified that any Producer-Handler who had a plant within the geographic bounds of a federal milk marketing order, but shipped milk into a state order, was nonetheless subject to the minimum and uniform price requirements of the federal order in which the plant was located. Congress thus addressed a specific and unfair situation where a plant operator could potentially take advantage of an unintended loophole between state and federal regulation that would otherwise be allowable under the AMAA.

Second, in subsection (N), Congress directed that for the purposes of Order 131 (Arizona), Producer-Handler status would apply only where a Producer-Handler had fluid milk sales of less than 3 million pounds per month.

Congress made clear that these two provisions were to be considered exceptional to the general rules applying under the AMAA by prefacing both subsections with the introductory

phrase “notwithstanding any other provision of this section.” Congress also made clear that these sections could not be interpreted as altering the basic law that applied to producer-handlers or the Secretary’s existing authority to regulate them. Immediately following these two subsections is subsection (O) entitled “Rule of Construction Regarding Producer-Handlers”, which expressly provides that “Subparagraphs (M) and (N) shall not be construed as affecting, expanding, or contracting the treatment of producer-handlers under this subsection except as provided in such subparagraphs.”

During the course of the hearing, opponents of NMPF’s Proposals have suggested that the MREA somehow limits the Secretary’s authority to accept NMPF’s proposals. See e.g. Tr. 826 (Comments of Mr. Ricciardi) These arguments have been somewhat cryptic (“it will involve a long explanation [and] I’m not going to go through it”) and it is clear why. Congress could not have been clearer in the language of the MREA that it had no intention of changing the general law that applied to producer-handlers, and no intention of limiting the Secretary’s historical authority to make decisions on whether and how to regulate these entities. The MREA addresses two limited factual circumstances and nothing more.

VI. CONCLUSION

This hearing conclusively documents the urgent marketing issues in the Federal Order System concerning producer-handlers. The extensive record compiled in this twelve (12) day hearing presents the Department with the opportunity to take important action to correct present disorder in the system and make the system operate in the interests of all producers and all handlers. The central, critical facts, well supported by the record, which mandate the required action are:

- Exempt producer-handlers have a cost advantage over handlers which are fully regulated because producer-handlers are not required to pay into the pool.
- More and more dairy farmers are becoming larger and larger and more new very large dairy farms are being built. Some of these farms will be producer-handlers.
- Exempt producer-handlers are a competitive factor in the commercial marketplace in competition with fully regulated handlers.
- The integrity of the fundamental Federal Order principle of marketwide pooling of Class I values among all producers is at risk.

NMPF urges the Department to adopt Proposals 1, 2 and 26. We thank the Department for its consideration.

Respectfully Submitted,

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NATIONAL MILK PRODUCERS FEDERATION COOPERATIVES

| COOPERATIVE | Annual Volume (2007) (Billion lbs) | MEMBERS |
|---|---|----------------|
| Dairy Farmers of America, Inc. | 37.1 | 10,587 |
| Land O'Lakes, Inc. | 12.5 | 3,015 |
| Northwest Dairy Association | 7.8 | 566 |
| Dairylea Cooperative, Inc. | 5.7 | 2,250 |
| Associated Milk Producers, Inc. | 5.5 | 3,600 |
| Manitowoc Milk Producers Coop. | 4.7 | 2,890 |
| Foremost Farms USA | 4.7 | 2,400 |
| Select Milk Producers | 4.4 | 83 |
| Michigan Milk Producers Association | 3.7 | 1,515 |
| United Dairymen of Arizona | 3.0 | 87 |
| Maryland & Virginia Milk Producers Assn. | 2.9 | 1,505 |
| Southeast Milk, Inc. | 2.8 | 314 |
| Agri-Mark | 2.5 | 1,377 |
| Lone Star Milk Producers | 2.3 | 249 |
| Upstate Niagra Cooperative | 1.5 | 408 |
| Continental Dairy Products | 1.5 | 23 |
| Swiss Valley Farms Company | 1.4 | 838 |
| Prairie Farms Dairy | 1.4 | 789 |
| First District Association | 1.3 | 832 |
| St. Albans Cooperative Creamery | 1.2 | 501 |
| Zia Milk Producers | 0.7 | 17 |
| Farmers Cooperative | 0.7 | 78 |
| Ellsworth Cooperative Creamery | 0.6 | 491 |

| | | |
|--|--------------|--------------|
| Tillamook County Creamery Association | 0.6 | 120 |
| Midwest Dairymen's Co. | 0.2 | 156 |
| Humboldt Coop. Creamery Association | 0.2 | 48 |
| Cooperative Milk Producers Association | 0.2 | 102 |
| Arkansas Dairy Cooperative Association | | |
| Just Jersey Cooperative | | |
| Scioto County Cooperative Milk Producers' Association | | |
| TOTAL: | 111.1 | 34841 |

Taken together, NMPF proposes to delete Section 10 in Parts 1001, 1005, 1006, 1007, 1030, 1032, 1033, 1124, 1126, and 1131, and all references to those sections and to “producer-handlers”, and to amend Section 8 in Part 1000, as follows:

§ 1000.8 Nonpool plant.

Nonpool plant means any milk receiving, manufacturing, or processing plant other than a pool plant. The following categories of nonpool plants are further defined as follows:

(a) A plant fully regulated under another Federal order means a plant that is fully subject to the pricing and pooling provisions of another Federal order.

~~(b) Producer-handler plant means a plant operated by a producer-handler as defined under any Federal order.~~

~~(c) Partially regulated distributing plant means a nonpool plant that is not a plant fully regulated under another Federal order, a producer-handler plant, or an exempt plant, from which there is route disposition in the marketing area during the month.~~

~~(d) Unregulated supply plant means a supply plant that does not qualify as a pool supply plant and is not a plant fully regulated under another Federal order, a producer-handler plant, or an exempt plant.~~

~~(e) An exempt plant means a plant described in this paragraph that is exempt from the pricing and pooling provisions of any order provided that the operator of the plant files reports as prescribed by the market administrator of any marketing area in which the plant distributes packaged fluid milk products to enable determination of the handler's exempt status:~~

~~(1) A plant that is operated by a governmental agency that has no route disposition in commercial channels;~~

~~(2) A plant that is operated by a duly accredited college or university disposing of fluid milk products only through the operation of its own facilities with no route disposition in commercial channels;~~

~~(3) A plant from which the total route disposition is for individuals or institutions for charitable purposes without remuneration; or~~

~~(4) A plant that in all markets has route disposition and packaged sales of fluid milk products to other plants of ~~150,000~~ 450,000 pounds or less during the month, all of which are uniquely branded.~~

~~(5) A distributing plant that was operated during 2008 by a producer-handler in a Federal order market within the meaning of the Federal milk marketing order at that time, provided that the plant:~~

~~(A) Has route disposition in all markets and packaged sales of fluid milk products to other plants in all markets that are uniquely branded and total 3,000,000 pounds or less during the month.~~

~~(B) Receives no fluid milk products, and acquires no fluid milk products for route disposition, from sources other than own farm production;~~

~~(C) The plant disposes of no other source milk as Class I milk except by increasing the nonfat milk solids content of the fluid milk products received from own farm production; and~~

~~(D) Provides proof satisfactory to the market administrator that the care and management of the dairy animals and other resources necessary to produce all Class I~~

milk handled, and the processing and packaging operations, are the plant owner's own enterprise and are operated at the plant owner's own risk, and that the plant owner has no interest in any other distributing plant (except through membership in a Capper-Volstead cooperative association) or in any farms from which the plant does not receive milk. The burden rests upon the handler who is designated as exempt under subsection (5) to establish through records required pursuant to §1000.27 that the requirements of such exemption are met.

**Estimation of Annual Sales by the 7 Largest Producer-Handlers
Based on Exhibits 7 & 20**

Exhibit 20

Producer-handlers by size group:

| | Number | | Mid-range | Minimum |
|-------------------|-----------------|-------------------|-------------------|------------------|
| Max volume | in group | Max volume | volume | volume |
| <i>150,000</i> | 7 | 1,050,000 | 525,000 | 0 |
| <i>300,000</i> | 13 | 3,900,000 | 2,925,000 | 1,950,000 |
| <i>1,000,000</i> | 6 | 6,000,000 | 3,900,000 | 1,800,000 |
| <i>2,000,000</i> | 4 | 8,000,000 | 6,000,000 | 4,000,000 |
| Totals | 30 | 18,950,000 | 13,350,000 | 7,750,000 |

If GH Dairy monthly sales are:

| | | GH = 4 mil | GH = 16 |
|-------------------|-----------------------------------|-------------------|-------------------|
| Exhibit 7: | Fluid sales by P-H's in Dec. 2008 | 56,883,000 | 56,883,000 |
| | GH assumption | 4,000,000 | 16,000,000 |
| | Total Dec. 2008 | 60,883,000 | 72,883,000 |
| Annual | Times 12 months | 730,596,000 | 874,596,000 |

Sales by p-h's >2,000,000

| | | | |
|----------------------|-------------|-------------|-------------|
| Minimum, subtract: | 227,400,000 | 503,196,000 | 647,196,000 |
| Mid-range, subtract: | 160,200,000 | 570,396,000 | 714,396,000 |
| Maximum, subtract: | 93,000,000 | 637,596,000 | 781,596,000 |

Exhibit 20: Number of p-h's >2,000,000 7 7

Average annual sales by p-h's >2,000,000

| | | |
|------------|-------------------|-------------|
| Minimum: | 71,885,143 | 92,456,571 |
| Mid-range: | 81,485,143 | 102,056,571 |
| Maximum: | 91,085,143 | 111,656,571 |

NMPF

7/17/2009