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BEFORE THE UNITED STATES
DEPARTMENT OF AGRICULTURE
AGRICULTURAL MARKETING SERVICE

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In the Matter of:	:	Docket No.:
Milk in the Mideast	:	AO-166-A68
Marketing Area	:	DA-01-04
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BRIEF ON BEHALF OF VARIOUS MILK DEALERS REGARDING PROPOSED CHANGES TO ORDER 33

I. INTRODUCTION

Federal Order Reform became effective in January of 2000. One of the significant effects of that Reform was to make it possible for producers, especially large co-operatives, to take advantage of favorable market conditions in areas of the country other than those to which they actually ship the bulk of their milk. For example, Order 33 made it much easier for producers to qualify their milk for payment under the terms of that Order without actually shipping a significant amount of milk to the geographical area covered by that Order (the"Marketing Area").

Specifically, Order 33 allows producers to sell their milk to plants located in the Marketing Area and qualify for payments under the Order even though most of the milk sold is never shipped into the Area. Instead, the purchasing plant resells (diverts) most of that milk directly to other plants located in the marketing area in which the milk was produced. This series of paper transactions ("paper pooling") results in the original purchasing plant, located in the

Order 33 Marketing Area, seeing little of the milk it purchases from the out-of-Order producers. Instead, most of the milk is shipped directly to the ultimate user and purchaser of the milk outside the Order 33 Marketing Area. Nonetheless, if relatively minimal delivery requirements are met, that milk is eligible for payment under Order 33.

Order 33 has, since the implementation of Federal Order Reform, had a higher Producer Price Differential than several other Orders. To take advantage of this higher differential, producers from those other Orders, especially the Midwest Order, have found it advantageous to qualify their milk for payment under Order 33 even though they deliver only minimal amounts of milk into the Order. As a result, there are many more producers and much more milk participating in the Order 33 pool than would otherwise be the case and much more milk than is necessary to meet the needs of the Order 33 Marketing Area. And, producers actually shipping milk to plants within the Order receive significantly less out of the pool than would be the case without this so-called "paper pooling." In addition, Class I plants within Order 33 end up paying more than they otherwise would have paid in order to keep independent producers from shipping their milk elsewhere. N.T. 331.

Largely as a result of this increase in "paper pooling," several parties petitioned USDA for a hearing regarding possible changes to Order 33. In all, nine proposals were received, most of which addressed the issue of paper pooling, seeking to make it harder to pool milk in the Order without actually shipping milk into the area. Proposals 1-3, 5-7, and 9. However, .two other issues were raised as one party asked for a change in the method of calculating the payment made to farmers in advance of calculating the final blend price and another proposal asked that the ability of cooperatives to pull their milk out of the pool be somewhat limited. Proposals 4 and 8.

A hearing was held in Canton, Ohio on October 23 and 24, 2001, at which testimony was received regarding those nine proposals. Among those participating at that hearing were the following dairies: Dean Dairy Products Company, Schneider's Dairy, Inc., Turner Dairy Farms, Inc., Carl Colteryahn Dairy, Inc., Marburger Farm Dairy, Inc., Fike's Dairy, Inc., United Dairy, Inc., Superior Dairies, Goshen Dairy, Smith Dairy Products and Reiter Dairy (the "Dealers").

The Dealers generally believe that the requirements for pooling milk on Order 33 must be tightened to reduce the amount of milk pooled in Order 33 which does not serve the Order or even help to balance the supply of milk in the area. They believe that, with a slight modifications, Proposal Three is the best of the Proposals submitted to accomplish that purpose. They support Proposal Two to the extent that it would eliminate the "free ride" for supply plants and oppose Proposals One, Five, Six, Seven and Nine only because they believe that Proposal Three addresses the same issues in a better manner. They will also address and oppose Proposal Four and support Proposal Eight. Proposal Four seeks to change the method for calculating the advance payments. Proposal Eight seeks to limit the ability of Class III and IV plants to de-pool their milk. Finally, the Dealers fully agree with all of the other participants in the hearing that this matter should be decided on an expedited basis.

II. PROPOSALS TWO AND THREE – THE DEPARTMENT SHOULD ELIMINATE THE FREE RIDE PERIODS AND INCREASE THE TOUCH AND DIVERSION REQUIREMENTS IMPOSED ON PRODUCER MILK UNDER SECTIONS 1033.7 AND 1033.13 OF THE ORDER

The Dealers agree with the proponents of Proposal Two and Three that the Department should eliminate the so-called "free rides" allowed by the present Order. They also agree with the proponents of Proposal Three that the Department should increase the so-called "touch" requirement as well as the limitations on diversions.

Here, there are two free ride provisions under the present Order. Under Section 1033.7, a supply plant can qualify its milk for payment under Order 33 even though it makes no deliveries whatsoever to a distributing plant during the months of March through August so long as it made sufficient deliveries during the months of September through February. N.T. 46. Similarly, under Section 1033.13, a producer can qualify its milk for payment out of the pool throughout the year by meeting minimum diversion requirements in the months of September through February even though all of its milk is diverted out of the Marketing Area in the remaining six months of the year. N.T. 47-48.

In addition, the only requirement that a producer actually deliver some milk to a pool plant (rather than having all of its milk diverted without delivery to the pool plant) is limited to one day's production and applies only in the months of September through November. Section 1033.13 (d) (2). Even this minimal requirement does not apply to a producer entering the area for the first time during the months of December through August.

Under these provisions, a supply plant and producer can qualify almost unlimited amounts of milk for payment out of the Order 33 pool during the free ride months by shipping only minimal amounts of milk into the Marketing Area during the months in which shipping requirements and diversion limitations apply. As a result, the amount of milk pooled in the Order 33 Marketing Area increased 29%, over 300,000,000 pounds, between December of 1998 and December of 2000. Exhibit 5, p. 28. The amount of milk pooled from outside the Marketing Area increased 46.24%, over 500,000,000 pounds, from 12.46% of the total to 35.91% of the total, between May of 2000 and May of 2001. Exhibit 5, p. 22. The number of producers drawing from the pool has also increased dramatically, from 10,006 to 11, 365 between 2000 and 2001. Most of that increase came from outside the Marketing Area. Id. For example, the number from Wisconsin increased from 627 to 2361 between 2000 and 2001 and the number from Minnesota increased from 0 to 117.

In contrast, there was a significant decrease in the amount of milk disposed of at pool plants as Class I dispositions fell over 2,000,000,000 pounds between 2000 and 2001, Class II dispositions fell over 750,000,000 pounds and Class IV dispositions fell over 550,000,000 pounds. Exhibit 5, pp. 10, 11 and 13. Only Class III pounds dispositions rose, but only by 1,300,000,000 pounds. Exhibit 5, p. 12. Thus, while the amount of milk drawing from the pool increased dramatically, the amount of milk actually servicing the Marketing Area fell.

Several witnesses attempted to calculate the effect of this "paper pooling" on the Producer Price Differential. To do so, they compared the actual payments made to those which would have been made if not for the payments made to producers which had not traditionally been associated with Order 33. Elvin Hollon, testifying on behalf of DFA et al., estimated the PPD lost because of those payments to the "non-traditional" producers, in the months of December 2000, March 2001 and June 2001 was $0.71, $0.57 and $0.34. Exhibit 13, Table 9.

He estimated the total loss (the amount paid to non-traditional producers) for those months to be $7,018,914, $5,665,772 and $3,733,812 respectively. Exhibit 13, Table 9.

Carl Herbein, testifying for the Dealers, estimated the losses for the months of January 2001 through August of 2001. Exhibit 21. According to Herbein, losses for that period ranged from $0.31 to $0.72 and the loss for the entire period was $0.55. Exhibit 21. He estimated the total money paid from the pool during that period to non-traditional producers totaled $44,565,926 – 27.1% – of the total pool.

Since there has been no increased demand for milk, and no significant change in market conditions for years (N.T. 239), it seems fair to assume that the increase in milk pooled on Order 33 was attributable primarily to increased ability to take advantage of the favorable market conditions in Order 33 through paper pooling. There is no other logical conclusion. Yet, it is impossible to state a rational justification for this result, and not surprisingly, not one party attempted to do so at the hearing.

The Dealers support the proposed changes in Proposals Two and Three that would eliminate the free ride provisions by imposing shipping requirements and, diversion limitations throughout the year. They also support Proposal Three insofar as it increases the limitations on diversions during the months that are already regulated.

The Dealers also support an increase in the number of day's production that a producer must deliver to a pool plant. However, they propose an increase in that requirement to three day's production rather than the two day's production set forth in Proposal Three. While admittedly the Dealer's proposal is the result of an informal survey and compromise, there was no evidence offered in support of the two day proposal. Three days would be more in line with that of other higher utilization markets such as Federal Order 5 which requires the equivalent of five days and Federal Order 7 requires 13 the equivalent of 10 days. N.T. 268.

The Dealers also support the proposal that would require physical delivery to a pool plant of the equivalent of at least two day's milk production during each of the months of December through July for producers who did not comply with the physical delivery requirement in each of the preceding months of August through November. The present provision, which allows participation based on a single day's delivery during the months of December through July, makes the delivery requirement essentially irrelevant.

Finally, the Dealers believe that the change proposed in Proposal One is unnecessary. N.T. 376. While admittedly that position is based on an informal survey among the Dealers, Proposal One is based on a similar survey of DFA customers, who are dealers like the Dealers. N.T. 263-64, 271. It seems inappropriate to pick one survey over another to change the present Order.

III. PROPOSAL FOUR – THE DEPARTMENT SHOULD NOT CHANGE THE METHODOLOGY USED TO CALCULATE THE ADVANCE PLACEMENT

Proposal Four seeks to change the methodology used to calculate the payment that handlers must pay at the end of the month, prior to the calculation of the final blend price. Under that proposal, handlers would be required to pay 110% of the lowest announced class price for the preceding month, less proper deductions authorized by the producer in writing. They are presently required to pay 100% of the lowest announced class price for the preceding month. The Dealers object to this proposal on the grounds that it would unfairly shift additional financial burdens to them with only minimal benefit to the producers.

Here, it is important to remember that the advance payment requirement was changed under the Federal Order Reform which took effect in January of 2000. Under the Reform, the date on which the advance payment is due was moved from the last day of the month to the 26th day of the month. N.T. 322. In addition, the date of the final payment was advanced one day. Obviously, the effect of these changes was to benefit producers by providing earlier payment and burden handlers by depriving them of the use of the advanced and final payment money for the number of days that the payments had been advanced.

Carl Herbein calculated the effect of that change and estimated that the cost of that change to handlers, in money terms, was approximately $823,000, consisting of interest lost as a result of the earlier payments. Exhibit 21; N.T. 323-25.[1] As importantly, he noted that having to make earlier payments also caused some dealers to draw on their lines of credit earlier creating potential cash flow problems. N.T. 324.

Proposal four would impose additional burdens on the handlers, requiring them to pay more money in advance. Mr. Herbein again calculated the annual effect of that change and determined that it would cost the handlers approximately $402,000 in interest each year. Exhibit 21; N.T. 327-28. Of course, it would also have an adverse effect on the handlers' lines of credit.

As Mr. Herbein explained, the Dealers do not wish to change the system to regain the moneys they are losing as a result of the earlier date. They do object to being asked to shoulder additional burdens when the benefit to the producers will be almost minimal.

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[1]Mr. Herbein calculated the amount of the advance payment and the amount of interest that was lost on that money as a result of the early payments. Id.

For example, there are over 11,000 producers pooling their milk under Order 33. Exhibit 5, p. 18. If, in fact, the benefit/burden created by Proposal Four is approximately $400,000 annually (proponents of Proposal Four argued that it was less), the average annual benefit to each producer would be less than $40 per year, less $4 per month. What is the point of changing the payment system to accomplish so little benefit?

Of course, the argument may be made that the average burden on handlers would also be relatively low. However, that is not necessarily true. According to Herbein, the average burden on the 47 handlers located in the marketing area would be over $8,500 per year. N.T. 354. That is not an insignificant amount in an industry in which margins are low. N.T. 372.

Handlers and producers have adjusted their operations to take into account the earlier payments required under Federal Order Reform. Several producers testified that they have scheduled their loan payments knowing when and approximately how much they will be paid and, therefore did not view changes in the advance payment to be significant. N.T. 81, 82, 84. There is no reason to make them, and the handlers, juggle their obligations again.

Moreover, it would not be fair to impose additional burdens on the handlers. Producers are essentially guaranteed that they will receive full payment for their milk by a date certain. N.T. 439. On the other hand, handlers have no guarantee as to when or even whether they will get paid. N.T. 424. And, in fact, handlers have seen a slowing in accounts receivable over the past ten years. N.T. 339. Finally, while producers can negotiate with their creditors (N.T. 425), handlers have no ability to negotiate the timing or amount of their largest obligation – the payment for raw milk. N.T. 425, 444 (the cost of raw milk is approximately 60% of the total cost of any container of a fluid milk product). Thus, there is no reason to believe that the handlers are better able to absorb the cost of larger advance payments.

In this regard, the figures submitted in support of this proposal are somewhat misleading in that they compare the advance payment and the ultimate blend price during a period in which the blend consistently rose from month to month. Exhibit 22; N.T. 437. Obviously, as prices increase, any advance payment based on 100% of a prior month's price will be lower than the ultimate blend price. However, when prices fall, the advance payments, based on higher prior month prices, will often exceed the ultimate blend price. N.T. 437. Payments based on 110% of the prior month's price will almost inevitably be higher. And, even the proponents of Proposal Four admitted that handlers would have some problems recouping overpayments. N.T. 415.

Moreover, it is likely that those handlers that purchase milk for Class III and IV uses will make advance payments which are consistently higher than the ultimate payment for which they are responsible. N.T. 451. Since traditionally they pay lower premiums, they will have even more problems recovering their overpayments.[2]

In short, the Dealers agree that the producers serving the Order 33 Marketing Area need relief. However, that relief should be provided by reducing the amount of milk drawing from the Order 33 pool which does not serve that Marketing Area. It should not be provided by increasing the burden on the handlers because the relief provided to the producers would be inconsequential while the effect of that increased burden on the handlers is potentially significant and, in any case, unfair.

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[2]Proponents of Proposal Four pointed to the possibility of offsetting overpayments against premiums as a potential means of recovery. N.T. 415.

IV. PROPOSAL EIGHT – THE DEPARTMENT SHOULD LIMIT THE ABILITY OF SUPPLIERS TO DE-POOL THEIR MILK

Proposal Eight seeks to correct a problem commonly known as de-pooling. De-pooling occurs when one or more of the class prices is higher than the blend price and the handler reporting pounds of the higher valued classification does not put them on their pool report.[3] Thus, the value derived from those poolings do not get entered into the blend price pool. N.T. 501. As a result, producers whose milk remains in the pool are hurt because there was less money available from the pool. Id.

In addition, Pennsylvania handlers are subject to state minimum prices that was higher than the blend price. As a result, when there is a price inversion, they have to pay class prices for their milk and cannot take advantage of the higher Class prices. Obviously, those handlers, mostly co-operatives, who can take advantage of the inversion by de-pooling their milk have a significant competitive advantage.

According to Carl Herbein, in the past, de-pooling has caused instability, causing milk to want to move in directions that it wouldn't normally move. N.T. 332. In order to eliminate this instability, the Dealers request that Section 1033.7 (C)(4) be amended to require any handler choosing to de-pool its milk to stay out of the pool for at least six months. This requirement would have the effect of limiting the incentive to jump in and out of the pool because of very short term price inversions and preventing the instability which results from such actions.

In this regard, it is only fair that those handlers who benefit when the blend price is higher than the Class III and IV prices should support the pool when they are not.

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[3]It is apparently unlikely that similar price inversions will occur given the new pricing mechanisms. However, if that is the case, there is no need to allow de-pooling at all. N.T. 343.

Respectfully submitted,

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CERTIFICATE OF SERVICE

On this 12th day of December, 2001, I, Patricia Z. Glusko, a secretary in the law offices of Duane, Morris & Heckscher LLP, hereby certify that I have served this day true and correct copies of the attached document in the above-captioned case, by depositing same in the United States First Class Mail, postage prepaid, in Harrisburg, Pennsylvania, to those persons and addresses indicated below:

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