

USDA
CINCINNATI
APR 17 11 3 24
FBI

UNITED STATES DEPARTMENT OF AGRICULTURE
BEFORE THE SECRETARY OF AGRICULTURE

In re:) Docket Nos.
Milk in the Northeast, Appalachian,) AO-14-A78, *et al.*;
Florida, Southeast, Upper Midwest,)
Central, Mideast, Pacific Northwest,)
Southwest, and Arizona Marketing)
Areas) DA-09-02; AMS-DA-09-0007

POST-HEARING BRIEF OF
DR. WILLIAM SCHIEK, DAIRY INSTITUTE OF CALIFORNIA

This post hearing brief is being submitted on behalf of the Dairy Institute of California, a trade association representing fluid milk processors and dairy product manufacturers operating plants in California. Pending before the United States Department of Agriculture (“Department”) are proposed amendments concerning the exempt status of producer handlers (“PHs”) under the Federal Milk Marketing Orders (“Orders”). The hearing on these matters was held on May 4-19, 2009 in Cincinnati, Ohio. While California plants largely operate under a state milk pricing and pooling program, several of our member companies operate plants that are subject to regulation under the Orders. In addition, member companies operating under California’s state milk pricing and pooling system have experience competing against producer-handlers that have a limited-volume exemption from minimum pricing and pooling. The five producer handlers which are eligible for this exemption in California retain their exemption even as their total milk volume grows beyond the specified exemption limit. This type of exemption, often referred to as a “soft cap” exemption, is similar to one of the proposals under consideration at this hearing. Our purpose in filing this brief and in testifying at the hearing is to assist the Department in its analysis of the proposals and testimony provided at the hearing.

Impact of “Soft Cap” Producer Handler Exemption in California

In California, the producer-handler exemption has undermined the state’s milk regulatory programs. It has conferred a milk cost advantage to the PHs equal to the difference between the regulated Class 1 price and the relevant pool price, which in California is the quota price. Over the past nine years, the cost advantage enjoyed by PHs on their exempt milk has averaged 11.3 cents per gallon. Given that the exempt portion of PHs Class 1 sales was 17.5% during the most recent 12-month period, when the advantage on exempt milk is averaged over the PHs entire Class 1 sales volume, their advantage on all Class 1 products sold is about two cents per gallon. By experience, Class 1 handlers find that customers often will switch suppliers when they can realize a cost savings of a few hundredths of a cent per gallon. Fully-regulated Class 1 handlers in California find that

competing with PHs who have such a large cost advantage is difficult at best, and in many cases impossible. Analysis of historical data shows that PHs have increased their share of the California Class 1 market, while fully regulated handlers have seen their share of the market decline. The principle of equal raw product cost to handlers competing in the marketing area is violated by the PHs' exemption, while the state orders' Class 1 minimum prices, which are imposed on fully-regulated handlers, lead to an unequal playing field.

In general, the PHs exemption is incompatible with one of the goals of the milk marketing orders, namely that producers benefit from price discrimination because of the ability to extract higher prices from the market segment (Class 1) with the more inelastic (less price sensitive) demand. Through pooling, those greater revenues are shared and each producer benefits by receiving a higher overall price for his milk. By distributing revenues in this way, the orders aim to encourage orderly marketing in lieu of the destructive competition that eroded prices in the era prior to order regulation. The PH exemption undermines orderly marketing by removing the higher valued revenues from the pool.

Relevance of the California Experience

There were some objections voiced at the hearing as to the relevance of California's experience with PHs to this proceeding. The point that needs to be made is that California milk pricing system is not fundamentally different from that of the Orders. Both the Orders and the California system employ classified pricing, and both systems require handlers to pay those established minimum prices to the pool. Both systems' prices are determined by economic formulas that are based on the prices of manufactured dairy commodities. The price series used by both systems in their respective economic formulas, and the resulting regulated milk prices, have tracked each other quite closely for years. Both systems pool the milk revenues for the respective classifications of milk and require payment of pool prices to milk producers.

To be sure, there are some differences in the parameters of the pricing formulas and the manner of distributing pool revenues under the two systems, but in a larger sense, the systems are much the same. Therefore, California's experience with the kind of producer-handler exemption we have described would not be substantially different from what would be seen in the Orders if the Department were to adopt a similar PH exemption. To suggest that California's experience has no relevance to this proceeding, as some have done, is either the result of a fundamental misunderstanding of the economic principles underlying the Orders, or is an outright attempt to obfuscate the pertinent lessons of the California experience.

Explanation of Transfer Pricing as it Relates to the Producer Handler's Cost Advantage

There were some questions during cross examination regarding our calculation of the cost advantage enjoyed by PHs because of their exempt status. It is important to note that no matter how the transfer pricing between the farm portion of the PH operation and the

plant portion of the PH operation is valued, the PH is able to realize greater economic returns than a similarly situated farm and plant that are not integrated. The integrated firm (the PH) will either earn a greater return at the farm by paying itself the Class 1 price, or it will earn a greater return at its plant operation by virtue of the fact that the plant is paying the farm side of its operation less than the Class 1 price, which is the minimum price for milk that fully-regulated plants must pay. This particular cost advantage that the PH enjoys is not a direct product of any economies realized by their integrated farm and plant operations, but rather, it is a result of revenues that are not shared with the pool due to the PH's exempt status. In California, the amount of this revenue is simply the difference between the Class 1 price and the quota price. Under the Orders, the PH's cost advantage would be equal to the PH's pool obligation if it were fully regulated; that is, it would be the difference between the PH's plant blend and the pool price that its farming operation would receive if it were not part of the integrated operation. The calculation of the monetary value of this advantage is irrefutable. It is not a matter of opinion, but of simple accounting.

A Note on Economic Rents

Economic rents are earned anytime a factor of production receives a price greater than what would be required for that factor to be produced. Economists often call this rent "Producer's Surplus." In a policy context, the term "rent-seeking" can be accurately applied to any producer or group of producers' attempt to earn a larger surplus than they would receive in a competitive market. It is true that collective acts by producers to obtain agricultural policies which enhance price can be characterized as rent seeking. It is also true that the Orders can be characterized as the result of collective rent-seeking by dairy farmers. However, given that the Orders have been in place since the late 1930s and that they are sanctioned by Congress, they have become the competitive norm for the industry. Furthermore, given that we have a regulated dairy industry in the United States, it is equally true that attempts by individual producers to expand a regulatory exemption or to grow their operations to take greater advantage of an existing regulatory exemption, and by doing so earn greater profits than could be realized in the absence of the exemption, can also be characterized as rent-seeking behavior.

A Note on the Collective Political Influence of Producer Handlers Operating under the Orders

During the cross examination phase of our testimony, a question was asked regarding whether PHs in the Orders possess the same kind of political influence that they seem to have under the California pricing system. One observation that I can make would seem to suggest that PHs are able exercise considerable political influence. The Milk Regulatory Equity Act of 2005 (MREA) was passed by Congress in March 2006 and signed by the President in April of the same year. This legislation had the support of most of the dairy industry with the exception of various producer handlers, who opposed it. Legislative efforts by the industry to pass legislation similar to the MREA were initiated in 2002. Official Notice requested of the MREA and its Legislative History. The fact that producer handlers were able to hold off a largely unified industry effort to pass

this legislation for three and a half years is testimony to the fact that they are not without considerable political influence.

Conclusion

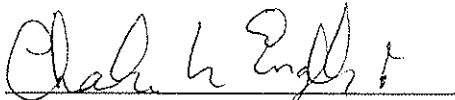
The soft-cap PH exemption has been shown to be disruptive to the California dairy industry. It has created an unbalanced competitive landscape and has led to a transfer of Class 1 market share from fully-regulated handlers to producer handlers. Dairy farmer revenues have been negatively impacted by the existence of this exemption. It violates California's legislative and regulatory goal of ensuring equal raw product cost to handlers operating within a marketing area. More generally, any unlimited exemption to minimum pricing and pooling regulations is fundamentally incompatible with such regulation. Even limited exemptions, if they are large enough, will undermine the goals that marketing orders were put in place to achieve. It is our view, that the Orders would be best served by the proposals (Proposal 1 and Proposal 2) contained in the joint petition that was submitted by the National Milk Producers Federation (NMPF) and the International Dairy Foods Association (IDFA) and considered at the Cincinnati hearing.

Respectfully submitted,

Dr. William A. Schiek
Economist
Dairy Institute of California

And

Respectfully submitted,



Charles M. English, Jr.
OBER, KALER, GRIMES & SHRIVER P.C.
1401 H Street, N.W.
Suite 500
Washington, DC 20005
(202) 326-5009

Attorneys for the Dairy Institute of California