

The Kroger Co.  
1014 Vine Street  
Cincinnati, OH 45223

June 1, 2016

Dana Coale, Deputy Administrator  
USDA – AMS – Dairy Programs  
Stop 0225, Room 2968 South Bldg. 1400 Independence Ave., SW  
Washington, DC 20250-0225

Re: Additional Proposal for hearing on multiple component pricing for Orders 5 & 7

Dear Deputy Administrator Coale:

The Kroger Company supports the proposed hearing on Multiple Component Pricing for the Southeast and Appalachian Federal Orders.

We ask USDA to also include the a proposal to lower the minimum amount of Class I Sales required a distributing plant to achieve pooling status from 50% to 25%. This would move the percentage to the same as the Northeast, Mideast, Central and Southwest Federal Orders, which all border Orders 5 and 7 to the North and West. Lowering the Class I utilization required to pool a plant will encourage more orderly marketing and provide potential for new producer milk sales in an oversupplied region by increasing the amount of Class II, III and IV milk a distributing plant can process while maintaining its ability to pool. We also believe it is consistent with the MCP arguments to make regulations more consistent with all but the orders that border 5 & 7.

Kroger is proposing to change § 1005.7 (a) and § 1007.7 (a) to allow a distributing plant with a minimum of 25% packaged fluid milk sales to qualify as a pool plant in the Southeast and Appalachian Federal Milk Marketing Orders. Current law requires 50% sales to qualify as a pool plant. This would allow distributing plants who process up to 75% of their monthly milk receipts for uses other than Class I to remain qualified as a pool plant under the Southeast and Appalachian Federal Orders. While we are not specifically requesting the percentage under change to § 1005.7 (b) and § 1007.7 (b) for ultra-pasteurized plants to also be changed to 25%, we would support USDA including a proposal to change the percentages in 7(b) to provide consistency across Federal Orders.

The Market Administrator has no current authority to change this requirement. It can only be accomplished by change in Federal Order code.

The Kroger Company operates 17 dairy plants that process Class I milk products across the US. 14 are regulated under Federal Milk Marketing Orders, 2 are regulated under the current California Milk Orders system, and one plant is unregulated due to location. Kroger operates 5

dairy plants in the two Marketing Orders included in this proposal: Atlanta, GA and Murfreesboro, TN are located within the Southeast FMMO and Kroger's Appalachian FMMO plants are in High Point, NC, Lynchburg, VA, and Winchester, KY.

Kroger Class I utilization in our 5 plants located in Orders 5 and 7 have an average Class I utilization of between 79-80% over the past two years, about 8-9 percent higher than the order averages. Utilization does vary by plant, due to a focus on Class II production in specific plants for efficiency reasons.

Kroger is not a small business as defined by the Regulatory Flexibility Act.

### **Background for this Request**

While milk production declines have slowed in the Southeast and Appalachian markets, Class I sales continue to decline, reducing the need for local Class I milk processing capacity over time.

As local production and demand for fluid milk has lessened, many plants, including fluid and other processing plants, have simply closed. In many cases, the loss of Class I sales have resulted in additional available manufacturing capacity in most of the remaining plants. Some distributing plants have used this capacity for other dairy products than packaged fluid milk, enjoyed by both consumers within the market, as well as outside the local Federal Order.

By consolidating production of Class II products to larger lines in fewer plants, these remaining plants have made more efficient use of their production assets while still serving local Class II demand with local plants – and local milk. This has helped these plants remain economically viable by broadening their product mix, maintaining or growing their milk demand, and maintaining or creating new farm milk sales for dairy producers and their cooperatives.

This has been the case for Kroger, where over time we have consolidated production of Class II products into specific Class I distribution plants across the country, allowing for better use of equipment capacity, processing expertise, and maintain reasonably close access to the end market – Kroger customers.

Kroger produces a wide range of Class II Products in our 5 plants located in the Appalachian and Southeast orders for our supermarkets in the region. The products include sour cream, cottage cheese, a wide variety of yogurts and frozen desserts including many varieties of ice cream and ice cream mix. Some of these products are distributed far beyond the region, even nationally in several cases.

We also manufacture products for other companies when it makes business sense to do so. These additional sales allow us to maintain plant efficiencies by processing more milk, and thus keeping them cost efficient enough to remain competitive. Our location in Southern markets gives us a logistics advantage to the large Southeast populations compared to more distant competitors. It also provides more market for local milk. In the Southeast we see that a good portion of the business opportunities have been with ice cream and other frozen dairy dessert products.

Despite the consolidation and expansion of our Class II operations over time, Kroger's five distributing plants operating in the Southeast and Appalachian orders have a weighted average Class I utilization of over 79% in both 2016 and 2017, well above the market averages for both orders.

Logically, the plants where we have consolidated our Class II production have a higher than average Class II utilization, and thus lower Class I utilization than our other plants in the region. We have consolidated these activities to improve efficiency and to keep production local, but we have also created a wider variation in Class I utilizations.

The largest users of Class II milk on a percentage basis are Hunter Farms (NC), where we produce cultured products and ice cream products, and Winchester Farms (KY), where we produce cottage cheese, sour cream and yogurt products. The addition of a Strained Greek Yogurt line at our Murfreesboro, TN plant this spring now requires additional farm milk for Class II processing.

Lowering the Class I distribution requirement will allow plants in the Southeast and Appalachian orders to meet seasonal demand spikes if Class I sales fall below 50%, keep more milk local, and lower balancing costs for raw milk suppliers.

The expansion of our Class II production capacities, combined with related sales opportunities have left Kroger vulnerable to the 50% Class I distribution requirement, particularly in our NC location. We have turned away business because of the risk of falling below the current 50% requirement during the summer months. Depending on plant volume, falling below the 50% requirement and the subsequent loss of pool status for only a few months of the year can cost a single plant hundreds of thousands of dollars over a short period of time. As a commodity business, dairy processing generally operates on very low margins, and this loss is not easily recovered.

Kroger's lost sales opportunities in NC due to this pooling requirement for one of our plants meant less product is being made in the Southeastern US than would otherwise occur. This production is being fulfilled by plants located in other markets – and not always owned by Kroger. As a result, this restriction did mean that additional local producer milk could not be used, and our cooperative suppliers moved milk further to find a home due to sales that have not come to the region.

Based on current capacities, we estimate that this one plant could use up to a million pounds more milk per month, if the 50% requirement were lowered. Under current rules, growing that capacity is currently out of the question. Lowering the distribution plant Class I sales requirement to levels consistent the surrounding MCP markets it makes addition of alternative processing capacity more attractive to Southeast and Appalachia plants.

Despite the seasonal surpluses, the amount of product demand needed to justify a new class II plant is prohibitive, and makes incremental growth in existing plants where Class I sales are declining more feasible economically.

**1. What is the purpose of the proposal?**

The proposal would reduce the required amount of Class I sales for a distributing plant from 50% to 25%, to allow for growth of other dairy product manufacturing. It will allow plants that process Class I milk to expand other dairy processing capacity at the same site with less risk of losing pool plant status. In turn, we believe it can provide additional opportunities to grow local milk demand, as described above.

**2. Describe the current Federal Order requirements or industry practices relative to the proposal.**

The pooling requirement included under § 1005.7 (a) and § 1007.7 is only changeable by rulemaking. The Market Administrator cannot make changes to the Class I sales requirement for distributing plants – it requires a formal rulemaking process.

The current restriction limits the amount of Class II, III, and IV product manufacturing that can be manufactured by plants also processing packaged fluid milk to less than 50% of total sales by volume. As milk supplies stabilize and the outlook for fluid milk continues to decline, companies like Kroger are looking for ways to use capacity by growing manufacturing or finding outside sales opportunities. In our case, it has grown Class II manufacturing in 3 of our 5 distributing plants located in the southeastern US.

In recent times, with production stabilizing, the need for additional local processing capacity has become more apparent. Many dairy companies operate multiple plants in a region, and Class II production has become more concentrated in specific plants for efficiency reasons.

As described above in the Request Background, the current requirements have already limited production in one plant in the Kroger system. It will impact plant growth when concerns over hitting the 50% packaged milk requirement is neared.

**3. Describe the expected impact on the industry, including on producers and handlers, and on consumers. Explain/Quantify.**

Handlers: Declines in fluid milk demand by consumers means that processing capacity growth must come from other dairy product sales. Handlers will be able to consider plant production expansion opportunities with less concern over the costs of depooling or having to balance the ability to grow sales with regulatory limitations. Fluid milk processing plants dominate the Appalachian and Southeast Markets. The most economical way to expand production capacity often requires use of existing assets, such as these plants, to minimize cost. Production lines are most efficient when they are operated at larger volumes in specific plants, rather than smaller volumes in many of them.

With buying power for packaged fluid milk consolidating with supermarket consolidation, Southeast and Appalachian Distributing Plants face more risk from falling below the 50% packaged sales requirement if they lose some of their business, and thus their ability to pool their remaining business.

Producers: Milk demand will have more opportunity to grow if existing plants can grow processing capacity for non-packaged fluid milk in Orders 5 and 7. Current plants could provide the base for expansion, lowering costs, which is much lower cost than a new standalone manufacturing plant.

The Appalachian and Southeast Federal Order markets can already make use of significant additional plant milk sales, as indicated by the recent loss of markets by dairy producers in both the Southeast and Appalachian Federal orders. Costs to balance local milk supplies by using distant plants will decline if current capacity is more fully used, or even expanded.

**4. What are the expected effects on small businesses as defined by the Regulatory Flexibility Act (5 U.S.C. 601-612)? Explain/Quantify.**

We believe the impacts of this proposal are neutral to manufacturers, as the proposed regulation change is based on percentage of sales into Class I, not volume. All sizes of plants could use this change to grow their milk processing business, with less concern of declining Class I sales impacting their future pooling status.

We believe this proposal would benefit dairy producers of all sizes due to the potential for increased local demand for milk. While Class I sales garner the highest regulated price, costs for balancing local supply/demand have created significantly lower producer mailbox prices. Growing local market demand for producer milk would help mitigate many of these costs.

**5. Explain the proposal. What is the disorderly marketing condition that the proposal is intended to address?**

The current Federal Order 5 & 7 pooling requirements for a Distributing Plant can limit the processing and sales expansion for plants with opportunities to grow sales of dairy products other than packaged fluid milk, if that growth results in sales of such products that greater than 50% of total milk use. This can have several onerous impacts on both distributing plants and producers in the local market.

- Restrict the ability of local distributing plants to maintain or grow production volume through other dairy product sales when Class I sales are declining nearly every year.
- Creates significant business risk for distributing plants that also produce products outside of Class I if they lose Class I sales tied to their plant and thus their pooling rights.
- Impact the demand for producer milk in these plants. If local demand is maintained or grows, the need to balance milk into distant markets at significant costs are lessened.

**6. How would the proposal increase or decrease costs to producers, handlers, others in the marketing chain, consumers, the Market Administrator offices and/or the Secretary? Explain/Quantify?**

We believe this proposal would not increase costs to any individual plants, but would enable plants to maintain their pooling rights if their product mix changes, allowing them to operate more efficiently. Class I Handlers would have more flexibility when planning for business growth, creating less regulatory risk due to lower class I sales. This is particularly important with supermarket mergers, where single shifts in Class I sales could endanger a Class I/II plant's pool status.

With additional manufacturing growth, all Producers would have opportunity for larger local markets for milk, lowering trucking and balancing costs. There should be no impact on the FMMO or USDA, as the proposed regulation change would not require any additional staff time. It only changes the pool status requirement and does not require additional work.

**7. Would a pre-hearing information session be helpful to explain the proposal?**

Kroger believes this proposal does not require a pre-hearing session. We believe it is a straight-forward recommendation that can be explained before a hearing determination through industry conversation and formally through the hearing process.

We appreciate your consideration of this proposal for inclusion in a hearing to consider multiple component pricing for the Southeast and Appalachian Federal Orders. Our suggested Federal Order Language change is attached to this request

Sincerely,



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CC: Harold Friedly  
Erin Taylor  
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Suggested Federal Order Language to accommodate the Kroger proposal:

**FMMO 5:**

**§ 1005.7 Pool plant.**

Pool plant means a plant specified in paragraphs (a) through (d) of this section, a unit of plants as specified in paragraph (e) of this section, or a plant specified in paragraph (g) of this section but excluding a plant specified in paragraph (h) of this section. The pooling standards described in paragraphs (c) and (d) of this section are subject to modification pursuant to paragraph (f) of this section:

- (a) A distributing plant, other than a plant qualified as a pool plant pursuant to paragraph (b) of this section or § ----.7(b) of any other Federal milk order, from which during the month ~~50~~ 25 percent or more of the fluid milk products physically received at such plant (excluding concentrated milk received from another plant by agreement for other than Class I use) are disposed of as route disposition or are transferred in the form of packaged fluid milk products to other distributing plants. At least 25 percent of such route disposition and transfers must be to outlets in the marketing area.
- (b) Any distributing plant located in the marketing area which during the month processed at least ~~50~~ 25 percent of the total quantity of fluid milk products physically received at the plant (excluding concentrated milk received from another plant by agreement for other than Class I use) into ultra-pasteurized or aseptically-processed fluid milk products.

**FMMO 7:**

**§ 1007.7 Pool plant.**

Pool plant means a plant specified in paragraphs (a) through (d) of this section, a unit of plants as specified in paragraph (e) of this section, or a plant specified in paragraph (h) of this section, but excluding a plant specified in paragraph (g) of this section. The pooling standards described in paragraphs (c) and (d) of this section are subject to modification pursuant to paragraph (f) of this section:

- (a) A distributing plant, other than a plant qualified as a pool plant pursuant to paragraph (b) of this section or § \_\_\_\_\_.7(b) of any other Federal milk order, from which during the month ~~50~~ 25 percent or more of the fluid milk products physically received at such plant (excluding concentrated milk received from another plant by agreement for other than Class I use) are disposed of as route disposition or are transferred in the form of packaged fluid milk products to other distributing plants. At least 25 percent of such route disposition and transfers must be to outlets in the marketing area.
- (b) Any distributing plant located in the marketing area which during the month processed at least ~~50~~ 25 percent of the total quantity of fluid milk products physically received at the plant (excluding concentrated milk received from another plant by agreement for other than Class I use) into ultra-pasteurized or aseptically-processed fluid milk products.