Before the United States Department of Agriculture
Agricultural Marketing Service

In the Matter of		: Docket Numbers
Milk in the Appalachian and	:	: **AO-388-A17** and
Southeast Marketing Areas	:	: **AO-366-A46**

Testimony of Dennis J Schad
On Behalf of Land O'Lakes, Inc
Regarding Proposal Five

January 10,2006

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Case US Dept of Agriculture
Deponent
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Exhibit ____

My name is Dennis Schad and I am here to testify on behalf of Land O'Lakes, Inc. I hold a bachelors degree in History from the College of William and Mary and a Masters in Business Administration from Virginia Tech. I have worked for Land O'Lakes and its predecessor cooperatives for twenty-five years and my current title is Director of Regulatory Affairs. Prior to this assignment, I have held positions in cooperatives' marketing and transportation departments. I have testified at numerous Federal and state milk marketing order hearings and before the agriculture committees of several state legislatures.

Land O'Lakes (LOL) is a dairy cooperative with over 4,000 dairy farmer member-owners. The cooperative has a national membership base, whose members are pooled on six different Federal orders. For over ten years Land O'Lakes and its processor cooperatives has provided a supplemental supply of milk to the Southeast. From that time Land O'Lakes' members have been continuously pooled on the Southeast orders.

Land O'Lakes Opposes Proposal 5

Prior to Federal Order Reform many orders had provisions that "zoned-out diversions." Typically an order would price milk at the order's pricing point and would price diversions as a mileage function away from that point. Sometimes the provision carried a stipulation that the price at the plant of diversion could be no lower than the Class III price.

Integral to Order Reform was the development of a national pricing surface which provided the relative price differences between geographic locations for milk and its components. In relative, rather than absolute terms, the Order Reform model provided an integrated national map, which defined the location value of Class I milk in the United States.

While never specifically addressed in the Final Decision, the Secretary chose to change the individual order zone-out pricing provisions to a system which priced diverted milk in a standard fashion for all orders, based on the Class I pricing surface. Nonetheless, the Secretary addressed a similar issue in a proposal for Order 1 in the Federal Order Reform process. **A** producer group pooling milk on the Northeast Order proposed that a producer pricing surface be overlaid on the Class I pricing surface. That Order 1 proposal would have provided a different uniform price to a producer delivering to a distributing plant in the same Class I pricing zone compared to a producer delivering to a manufacturing plant in the same zone. The Secretary denied this Order 1 proposal stating, "**A** producer pricing differential structure that differs from the Class I differential is denied." (This issue is discussed in Final Decision of Federal Order Reform in Part 6a, the Northeast Region, in the Section entitled, The Need for a Producer-Price Mechanism.)

Admittedly the issues which prompted the Order 1 proposal are different than the one in front of us today, however, the essence of Proposal 5 is to provide a producer uniform price for diverted milk different than the Class I pricing surface. To that point, the issues raised in the Federal Order Reform Order 1 proposal and Proposal 5 are the same.

Since the Reform process the appropriateness of pooling milk distant from an order's marketing area and that milk's participation in the Class I market have been addressed through the producer-qualification sections of the Federal orders, not the pricing sections.

Generally speaking, radiating from the Southeastern region the country, Class I milk prices decrease. The Class I pricing surface is lower in Indiana and Wisconsin than it is in Tennessee or North Carolina. Likewise the Class I value is lower in Texas and New Mexico than it is in Mississippi or Georgia. These relative differences in Class I values are also applicable to the blend price differences between milk delivered to plants in the in-area and out-of-area examples. Proponents of Proposal 5 would argue that the relative differences of the Class I pricing surface are inadequate to determine the value of diverted milk. They propose that the value of diverted milk should be updated to current transportation costs and be zoned out at a rate of four cents per ten miles. Others may contend that the pricing at the out of market plants is correct, but the Class I differentials in Southern orders should increase by four cents per ten miles from the orders' reserve plants.

The value of diverted milk at a plant could change, based on a change in pool status of the "closest pool distributing plant." Proposal 5, as written, could bestow an economic value to maintaining the pool status of distributing plant solely for the value of diversions. For instance, based on Proposal 5, the value of diverted milk at Carlisle, PA would have increased by $0.52 per hundredweight on November 1,2005 when Order 5 expanded its marketing area into Virginia, which resulted in the Morningstar plant at

Mount Crawford becoming pooled on Order 5. Now Carlisle is 115 miles nearer to the "closest pool distributing plant." Moreover, the regulatory-driven economic benefit from Proposal 5 could provide incentives for building balancing plants in the Order 5 and 7 marketing area, rather than in the milk shed of surplus milk production.

Prior to Order Reform and its resulting national Class I pricing surface, distributing plants shifted sales in order to qualify as a pool plant in the order with the lowest Class I price. Ignoring market economics, route distribution was shifted between distributing plants to gain regulatory advantage. Adoption of Proposal 5 could provide similar dis-economic incentives for maintaining a distributing plant or choosing the site for a balancing plant.

In the early 1990's when then Atlantic Dairy Cooperative first sold milk to the then Carolina-Virginia Cooperative, the sale was transactional. The milk was loaded out of Carlisle, an Order 4 pool plant, based on availability and price. As the relationship matured, the importing cooperative offered to facilitate the pooling of Middle Atlantic milk on Order 5 year-round. For Carolina-Virginia this new transaction guaranteed a first-option volume of milk at a known price for its Class I needs. From the larger market perspective, this change resulted in having all of the Order 5 producers sharing the cost of maintaining this supplemental supply of milk and having Order 5, rather than Order 4, receive the benefit of the Class I sales.

This transaction was further facilitated by provisions in the pre-reform Order 5 [1005.75 (a) and 1005.53 (a) (6)]which priced diversions to a plant located in the marketing area of the former Order 4 based on the Class I value at the plant of receipt.

Adopting a zone-out provision in Orders 5 and 7 would change the economics of providing a supplemental supply of milk to the Southeast. For instance, the value of milk diverted to Carlisle would decrease by $0.61 per hundredweight from its current value, reflecting the 168 miles between Carlisle and Mount Crawford, Virginia. Adoption of Proposal 5 would decrease the location value of diversions of milk to the Land O'Lakes cheese plant at Kiel by an estimated $1.38 per hundredweight as a function of the 457 miles between Hoosier Dairy in Holland, IN and Kiel Wisconsin.

As a consequence, there would be little economic incentive to maintain an on-call supply of Order 5 or 7 milk in the Northeast or the Upper Midwest.

In my opinion, the adoption of Proposal 5 would result in the return to supplying the deficit Southeast markets through transactual relationships. Milk to the Southeast would be sold out plants on an as available basis and at prevailing give-up charges.

If disorderly market conditions resulted in the change from the zone-out diversion pricing after Federal Order Reform, they have been addressed through the pooling qualification hearings in Orders 1, 30, 32 and 33 during the last five years. During the period, Orders 5 and 7 have not requested a hearing to tighten pooling qualifications.

Land O'Lakes believes the adoption of Proposal 5 would be disruptive to acquisition of supplemental supplies of milk to the Southeast orders and recommends that the proposal not be adopted.