

BEFORE THE UNITED STATES DEPARTMENT  
OF AGRICULTURE  
AGRICULTURAL MARKETING SERVICE

In the Matter of

Milk In The Northeast

Marketing Area

°

: Docket Nos.:

: AO-14-A70 et al;

: DA-02-01

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Testimony of

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on behalf of the  
Association of Dairy Cooperatives  
in the Northeast

ProposaI7

September 10, 2002  
Alexandria, Virginia

TESTIMONY OF  
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SR. VICE PRESIDENT  
AGRI-MARK DAIRY COOPERATIVE  
SEPTEMBER 10-13,2002  
ALEXANDRIA, VA

My name is Robert D. Wellington. I serve as senior vice-president for economics, communications and legislative affairs for Agri-Mark dairy cooperative. I have worked in that position for Agri-Mark for the last thirteen years. Prior to that I was employed by the Office of the Market Administrator, New York-New Jersey Milk Market area for eleven years. My position with the Market Administrator's office included senior economist and chief of research and cooperative relations.

Agri-Mark is a Capper-Volstead cooperative headquartered in Methuen, Massachusetts. We have approximately 1350 members located in the six New England states and New York. We market about 2.5 billion pounds of milk annually. Our members own and operate three manufacturing plants including a dedicated cheese plant in Middlebury, Vermont, a cheese and other dairy product plant in Cabot, Vermont and a butter and powder plant in West Springfield, Massachusetts.

I am testifying here today in support of proposal 7 which involves payments from the pool to handlers who perform marketwide services which benefit all producers in the Order. This testimony is on the behalf of the Association of Dairy Cooperatives of the Northeast (ADCNE). ADCNE consists of the following cooperatives: Agri-Mark, Dairy Farmers of America, Dairylea, Land O' Lakes, Maryland and Virginia Milk Producers, O-AT-KA, St. Albans and Upstate Farms. These organizations represent more than 65 % of the milk pooled in the Federal Order No. 1.

**WHY HAVE WE ASKED FOR CONSIDERATION OF PROPOSAL 7?**

The economic return for providing milk under the Northeast Federal Order for producer members of cooperatives who balance the Class I market is less than that of producers who do not participate in providing balancing services. This inequity has exists for many years but has grown since the current Order was promulgated on January 1, 2000.

The Agricultural Marketing Agreement Act of 1937 allows for the classification of milk and the pooling of the resultant value in order to create a common uniform price to all producers providing milk to the Federal Order market

Producer milk destined for Class I use is neither better nor worse than milk destined for any other class use at the time that milk is produced, at the time it is shipped from the farm nor at the time it is received at a Class I distributing plant. That milk only receives its higher value both under the Order and in reality when it is made and sold as a Class I assigned product. Prior to the existence of Federal Orders, producers competed in an attempt to capture that higher Class I value and leave the lower value uses for the milk of

their neighbors. However this strategy consistently failed as Class I distributors could and did obtain supplies from neighboring producers who were shipping to plants with lower value uses and were willing to accept a price only pennies above what they received at the manufacturing plants. Any producer who believes that the current Class I price represents the value of his specific milk because it is received at a Class I distributing plant is mistaken. In the absence of the Federal Order, he would receive essentially the same price as his neighbor shipped to a manufacturing price.

Assuring that the Class I needs of the market are met is a primary purpose of the Federal Order as defined in the 1937 Act as well as a means to maximize the price to all fanners who provide milk to the marketing area. This not only means having a sufficient total volume of producer milk available annually to meet the annual Class I sales, we believe it also means having the Class I milk available as it is needed on a daily basis all year long. One of the intents of class I differentials is to assure an adequate supply of milk. These differentials tend to be higher in higher Class I utilization markets. A part of the reason they are higher is because more money is needed to assure an adequate supply each day all year long. Balancing is part of that assurance and to some extent is included in the Class I differential. However the value of the higher Class I differential accrue to all farmers in the marketplace through a higher uniform price. While producers are crucial in providing for adequate year round supplies of milk to meet total Class I milk needs, producers do not balance Class I supplies in any way, shape or form. Producers ship as much or as little milk as they wish to make each day and, as will be shown, typically produce milk in a seasonally production pattern that actually runs counter to the Class I demand pattern. That part of higher Class I differentials that reflects balancing costs does not go to the parties that provide that service in the marketplace and that problem needs to be corrected.

Congress and President Reagan recognized that problem when they passed the Food Security Act of 1985 and specifically authorized marketwide service payments under Federal Orders. The dairy division of the agricultural marketing service of USDA explained it well in the following except from its findings and conclusions of May 1, 1987 (Federal Register/ Vol. 52, No. 84/ Friday, May 1, 1987/ Proposed Rules for Docket Nos. AO-366-A28 et al. which involved a hearing on marketwide payments for seven orders in the southern United States in 1986).

"Payments for services of marketwide benefit are specifically authorized under the Food Security Act of 1985. That law amended section 8(c)(5) of the Agricultural Adjustment Act, reenacted with amendments by the Agricultural Marketing Agreement Act of 1937, by adding the following provisions: '(J) Providing for the payment, from the total sums payable by all handlers for milk ... to handlers that are cooperative marketing associations described in paragraph (F) and to handlers with respect to which adjustments in payments are made under paragraph (C), for services of marketwide benefit, including but not limited to -

- '(1) Providing facilities to furnish additional supplies of milk needed by handlers and to handle and dispose of milk supplies in excess of quantities needed by handlers;
- (ii) Handling on specific days quantities of milk that exceed the quantities needed by handlers; and

(iii) Transporting milk from one location to another for the purpose of fulfilling requirements for milk of a higher use classification or for providing a market outlet for milk of any use classification.'

Market balancing activities, such as disposing of surplus milk and obtaining supplemental supplies for handlers, are clearly identified in the new provisions as services of marketwide benefit. The law also provides that payments made under the order program for the purpose of reimbursing the handlers who provide those services are to be made from the total sums payable by all handlers for milk. Thus, the objective under marketwide service payment provisions is that the minimum uniform price to all producers would be evenly affected (reduced) and all would share in the cost of providing the services. In this way, some market participants would not be able to maintain an advantage gained by receiving benefits but not having to pay the costs therefor. They would cease to be 'free-riders'."

We are here today in regard to Proposal 7 because all producers who pool their milk under the Northeast Federal order benefit from services that balance the Class I market. Those services facilitate the "ride" to a higher uniform price for all milk in the pool, but not all producers currently pay the fare for that ride.

### **WHAT ARE BALANCING COSTS AND WHY DO THEY EVEN NEED TO BE INCURRED?**

There are several types of balancing done in a milk market. Proposal seven deals exclusively with two types of balancing (1) daily balancing of class I needs and (2) seasonal balancing of class I needs. Balancing does occur across the entire milk supply in a marketing order because the production of milk by farmers, particularly on a seasonally basis, varies and that production pattern must be accommodated. One of our problems in the past with proposing marketwide service payments was to try to separate those costs of balancing the Class I market with the costs of balancing the entire supply of milk in the market. Our plants do not know whether the milk they receive (or fail to receive) is intended to balance the Class I market or the entire market. Plant managers just know if their operations are full or empty to some degree.

We know what our total plant costs are, but attributing those costs to explicit Class I balancing is almost impossible. That is why we turned to the approach used by Dr. Ling. His analysis used real data and reasonable assumptions to exclusively focus on the Class I related balancing costs. In reality, a butter/powder plant may run at even a lower capacity level in the fall than dictated by needed Class I balancing in order to accommodate the total seasonal fluctuations in all producer supplies, including cooperative members. Ling's study does not account for any of those costs nor should it. If such producer supply fluctuations resulted in the need for additional butter/powder plants to facilitate constant volumes of milk into Class III plants all year long, that costs would also not be included in the Ling study.

The attached figure 1 shows producer receipts per day classified as Class I under the Federal Order from January 1, 2000 to June 2002. Figure 2 shows total producer receipts

per day during the same period and Figure 3 shows the difference between the two. These figures used the data presented by Mr. Fredericks of the Market Administrators office (page 5 of exhibit \_\_\_\_\_) and divides each monthly volume by the number of days in each month.. The monthly variation is apparent from these graphs. Clearly there are times of the year when the volume of milk in excess of Class I needs is far greater than other times of the year and that milk must find a home.

Cooperatives have been providing balancing services for so long in the Northeast that most people take them for granted and are not concerned with their importance (until, of course, if they disappeared one day or if distributors are asked to pay for them). The electricity utility sector provides an analogy that I believe is useful in understanding our problems in balancing milk supplies. This past summer, the New England region, and many other areas of the country recorded record levels of electricity usage on a daily basis. The utility companies had to maintain sufficient electricity producing capacity to meet the higher days usage throughout the year even though that meant that on just about all other days they would have to have available (and incur the fixed costs) of unused capacity. They can not look at the annual average amount of electricity per day. That figure is meaningless for capacity purposes. Even the monthly average per day provides little value for capacity purposes. They must have the capacity to provide enough electricity on the peak day. Sure, they can try to buy some power from neighboring utilities to get them through their peak periods, but chances are that those other utilities are also facing peak demands and have little capacity to spare at the time it is needed.

The same happens in the dairy industry. Milk is highly perishable and must be processed quickly. Farmers can not store it because the next milking must be accommodated. You can not keep it in tankers very long, plus the tank and trailer are usually needed to pick up the next days milking. Storage capacity at plants is limited by health regulations and costs. In the past several years, several Class I plants in the Northeast have closed and further reduced the storage capacity of Class I milk in the market. Just like the peak of electricity, the peak of milk supplies relative to demand must be handled quickly.

Balancing milk in the Northeast involves providing consistent and immediate outlets for surplus milk as well as the ability to release or obtain additional milk when needed. Market balancers in the Northeast provide these services over large volumes of milk. Buying or selling a few spot loads of milk is not the same.

### **WHY HAVE COOPERATIVES PLAYED A UNIQUE ROLE IN BALANCING IN THE NORTHEAST?**

Cooperatives have played the primary role in balancing the northeast order market for more than sixty years. Ed Gallagher has already explained the unique marketing characteristics we face in this region. I again want to highlight that a key issue cooperatives face is that the Northeast has a huge number of milk producers who do not belong to a cooperative. I will refer to them as non-members. They number in excess of 4,000 according to Market Administrator and market about 6 billion pounds of milk annually (see Appendix Table 16 of Exhibit \_\_\_\_\_).

There are dramatic differences in the Northeast relative to how cooperative member and nonmember milk is used. Most of the nonmember milk is dedicated to supplying distributing plants on a year-round basis. As shown in Appendix Table 15 in Market Administrator Exhibit \_\_\_\_\_, the average classification of nonmember milk in the Northeast Order is about 80% Class I despite the fact that the Northeast is less than a 45% Class I utilization market year round. The milk from these nonmember farms is received at Class I distributing plants just about all the time.

Nonmember farms shipping to Class I processors make no special efforts to balance the seasonal or daily needs of their handler or the Class I market. To my knowledge, class I handlers do not limit the volume of milk picked up by those nonmembers in any way. Class I handlers do not ask those shippers to store milk from low demand days to high demand days. Those handlers don't refuse to accept their milk when schools go out of session or demand producers expand their herd in the fall and reduce it in the spring.

What Class I processors, who buy milk from nonmembers usually do, is buy a volume of farm milk that is no larger than their low month needs and use cooperative milk to balance their needs in the high usage months. Table 1 takes the Market Administrator data from page 5 of Exhibit \_\_\_\_\_ regarding producer receipts classified as Class I and then shows a column representing 118% of those Class I volumes in total and on an average per day basis. This adjustment represents one divided by .85 and is made because distributing plants have approximately 85% Class I milk, on average. The table then compares that with the product of multiplying the volume of non-cooperative producer receipts (from Appendix Table 17 of the same Market Administrator's exhibit) times the percentage of proprietary handler producer milk receipts delivered to distributing plants (from Appendix Table 15 of the same Market Administrator exhibit). The difference is an estimate for the amount of class I milk that is supplied by nonmembers during each month.

Table I also gives the volume per day for non-cooperative and cooperative producers as a percentage of the low month during the eighteen month period. For non-cooperative producers, the low point of receipts per day used as Class I milk was August 2001. The level of milk provided per day ranged from that low point to 12 percent higher in March and April of 2002. It is significant that the high point of deliveries of nonmembers was in the spring when Class I sales tend to be less than in the fall. Cooperative member receipts in the Class I market was at a low point in July 2001. However their deliveries needed for the Class I market peaked in November and needed to be 29 percent above the July low point. The seasonal high of the cooperative receipts for the Class I market was more than double that of nonmember receipts and occurred at a point when total milk producer is usually a seasonal low point. Clearly cooperative milk does far more balancing of the Class I market.

### **HOW DO WE BALANCE IN THE NORTHEAST?**

The Northeast Federal Order is an extremely large milk production and Class I demand area as indicated by Mr. Gallagher's testimony. Some areas such as the Upper Midwest have a large enough Class III industry that their smaller Class I market can be balanced

by slightly reducing the amount of milk received by a large number of cheese plants. However even that market must have at least **one or two butter/powder plants**. In the Northeast, the Class I market is too large to be predominantly balanced by cheese plants on an economic basis. Cheese plants play an important role as I believe Mr. Gallagher will indicate in his testimony, however butter and powder plants still play the dominant role in balancing the daily and seasonal needs of the market.

As previously noted, Agri-Mark operates a large, dedicated cheddar cheese plant in Middlebury, Vermont in addition to our butter/powder facility in West Springfield, Massachusetts and our mixed products plant in Cabot, Vermont. We rarely balance milk at the Middlebury plant due to the costs involved in doing so and the type of market we have for the products produced there. The costs and market type of products produced at West Springfield are much preferable for balancing.

The marketing and operations staff reviewed our current overhead costs at both our Middlebury and West Springfield operations. The complete overhead costs per hundredweight are \$1.02 cents per hundredweight of milk at our cheese facility and \$.61 per hundredweight at our West Springfield facility. In other words, if we remove a hundredweight of milk from Middlebury to serve the Class I market, we have \$1.02 in fixed costs that can not be recovered. If we remove that same hundred points of milk from West Springfield, we incur a \$.61 cent cost that can not be recovered. Our costs of balancing are lower by \$.41 per hundredweight when we use our butter powder facility. In addition, butter and powder are far more generic products than our award-winning cheddar cheese produced at Middlebury.

Figure 4 shows the Class IV volume of milk in the federal Order. The data from this table originates from page 5 of the Market Administrator Exhibit \_\_\_\_\_. I have duplicated that data in Table 2 because of its importance relative to this hearing. The extreme volatility in Class IV use can clearly be seen in both the figure and the Table 2. Class IV producer receipts were at or significantly above 249 million pounds for the first five months of year 2000 but were at or below 100 million pounds during August through November period of 2000. Based on our experiences at West Springfield, December 2000 likely had producer receipts in Class IV at below 50 million pounds for the first half of the month. Those receipts then likely rose above 100 million for the second half as schools closed and Class I and other plants reduced their bottling schedules during the holiday season.

In the year 2001, Class IV receipts peaked at 230 million pounds in the spring and were below 150 million pounds throughout the late summer and fall. The volatility was less in 2001 because volatility of total milk receipts were less.

In 2000, total milk receipts in the Northeast Order were one billion and seventy-six million pounds higher in the first six months of the year than in the last six months. This was a 9.4% difference. During that same year, Class IV receipts were 901 million pounds higher between the two time periods. Class IV plants absorbed 84% (901 divided by 1076) of the difference in producer receipts even though Class IV milk averaged less than 10% of total producer receipts during the year. Class IV volume had to fluctuate by

126% between the two halves of year in order to accommodate the change in total producer receipts.

In the 2001, total milk receipts in the Order were only 266 million pounds higher during the first six months of the year than in the last six months. This was a 2.2% difference. During the same year Class IV receipts were 215 million pounds higher during the same time periods. Class IV once again absorbed more than 80% of the difference in producer receipts even though it average less than 9% of total producer receipts in 2001. Class IV volume had to fluctuate by only 22% between the two half of the year. While that may look like a better economic situation for Class IV plants in 2001, it was actually a far worse year since total Class IV volume was down nearly 200 million pounds during the year and plants has far less volume to spread their fixed costs over.

Looking at the year 2002 so far, it is good that we did not reduce Class IV capacity last year. According to the table on page 5 of the Market Administrator exhibit, Class IV pounds during the first six months of 2002 are running 469 million pounds above the same months in 2001 and even 35 million pounds above 2000.

Table 2 also contains information on volume of milk manufactured at Agri-Mark's West Springfield, Massachusetts plants. This plant has a manufacturing capacity of about 2.2 million pounds of milk per day. We were essentially at full capacity in April 2000 when we used 65.4 million pounds of milk in that 30 day period. The low point that year, and for the past two and one half years was 19.4 million pounds in November, 2000. We were operating at less than 30% of capacity that month.

Appendix Table 14 of the Market Administrator exhibit \_\_\_\_\_ shows total receipts of milk and cream at the seven plants operated by the cooperative members of ADCNE. These plants include Agri-Mark's West Springfield facility. Information for the months of May and November between 1992 and May of 2002 is provided. These plants do a variety of activities including reloading milk, skim milk and, to a lesser extent cream, for sales to other handlers. Those activities, as well as the production of specialized products, including on demand specialized milk powders tend to be more valuable products and are a priority at the plants. The least priority is making skim milk powder and butter. Those are the two products that balance the class I market.

When one averages the amount of product into nonfat dry milk production in each May since 1992, the average is 220 million pounds. The amount in November is about 97 million pounds but is closer to 100 million pounds when the thirty days in November are adjusted to 31 days such as in May. The amount of product used for nonfat dry milk production is clearly more than double the production in May as it is in November overtime. The extremes during that time were 60 million pounds in November 1993 and 286 million pounds in May 2002.

Butter production tends to have somewhat less volatility. Class I sales averaging about 2% butterfat needs to balance proportionately more skim milk than butterfat in producer milk since producer milk averages nearly twice the butterfat level. For example, when Class I sales peak in the fall and larger amounts of milk are needed for that classification,



the producer milk received at distributing plants must be separated to generate milk averaging 2% butterfat. This separation produces a large volume of cream that is not needed for Class 1. The column marked "total cream receipts" in Market Administrator Appendix 14 reflects that occurrence. Most of that cream is coming from Class I distributing plants. Product manufactured into butter at the ADCNE plants averaged 14.2 million pounds in May and 8.3 million pounds in November (or 8.6 million pounds in November when adjusting for a 31 day comparison). Thus there was 66% more butter made in May than in November, on average at ADCNE plants.

Cooperatives seek the lowest cost method to balance reserve milk supplies in their areas. The use of supply arrangements with cheese plants may work in New York due to the proximity of such plants. That cost increases in New England because we do not have a concentrated cheese industry and the high transportation costs of bringing the milk against Federal Order zones back into New York. We have predominantly always used butter/powder plants to balance the Class I market. At one point, we had several small butter/powder plans in New England, but now we operate only one large plant. For Agri-Mark, we view this as the least cost option. However, based on their available nearby plants and other factors, other cooperatives may employ other options.

### **HOW CAN WE MEASURE THE COSTS OF BALANCING?**

It is very difficult to measure the costs of Class I balancing at an operating plant because it is almost impossible to isolate those costs and allocate them back to a Class I balancing function. Butter and powder manufacturing plants do many functions. They often reload milk for longer distance travel; they can separate milk and sell skim milk or cream; they can condense skim and sell that product directly; they can combine condensed skim, milk and cream in many combinations and sell them as blends: they can manufacture butter and they can manufacture dry milk powder. The powder could be high heat powder, low heat powder or whole milk powder. Some operations such as O-AT-KA also produce evaporated milk and package various milk based drinks.

At the Agri-Mark plant we also package butter in retail size container in addition to many of the functions I just mentioned. However we do not make any whole milk powder nor do we produce or package any milk-based drinks. We also do a tremendous amount of balancing of the Class I market at our plant in West Springfield.

Table 2 shows the volume of milk to manufacturing at West Springfield as a percentage of full capacity. In 2000 we ranged from running at 99% capacity in April to 29% capacity in November. In 2001, our spring peak was 75% capacity in May but we later peaked even higher at 81% capacity in December. The low point was September 2001 at 37% capacity. Our peak so far in 2002 was at 92% capacity in June. Figure 6 reflects that information shown in Table 2.

We have reviewed our overhead costs as they relate to the Ling study at various levels of capacity. Our costs data show that the costs per pound of product increases about .11 cents per pound for each 1 % drop in the plant capacity use. This further verifies the information used by Dr. Ling in his study.

As already noted, there are so many complex activities taking place at balancing facilities it is very difficult to pin point which should be associated with balancing and to what degree. At Agri-Mark's West Springfield operation the least valuable activities that involve balancing include receiving, condensing and drying/churning milk. Other activities such as selling condensed milk, cream and blends generate more value and would have a higher value than drying/churning. If you look at a plant running at full capacity and then remove milk volume from that plant, the removed volume at West Springfield will impact the dryer and chum first. Therefore one can look at the stranded costs of reducing powder and butter production as a measure of the costs of balancing in the matter reflected in Ling's study.

### **WHY IS DR. LING'S STUDY SO USEFUL?**

Ling's study isolates the costs of balancing at a plant from all the other activities occurring at the plant. His analysis uses real data and reasonable assumptions to exclusively focus the Class I related balancing costs.

The Ling study is a least-cost proxy for the actual costs of balancing. It assumes a best-case, least-cost balancing scenario where several large, efficient butter-powder plants handle the entire Northeast market's balancing needs. In the real world, the system is not so perfect and there are additional costs. These additional costs include the extra hauling costs needed to move milk to the already established location of balancing costs several decades ago while the milk supply area of the Order has shifted.

Dr. Ling begins his report with a discussion of the seasonal nature of milk in the marketplace. Table I of his report (Exhibit \_\_\_\_\_) shows indices of seasonality of producer milk deliveries and fluid demand. Clearly this table reflects the patterns we have seen in the marketplace. I have duplicated Ling's table using year 2000 and 2001 data from page 5 of the Market Administrator exhibit (Exhibit \_\_\_\_\_). In my Table 3, I used Class I volume per day as my measure of fluid demand. I used producer milk deliveries per producer for my production index. This is the same information used to generate my Figures I and 2 of this statement although it only uses the 24 months of year 2000 and 2001. This table mirrors Dr. Ling's table to a great degree.

Dr. Ling discusses three categories of milk reserves: operating reserves, seasonal reserves and excess reserves. Operating reserves and seasonal reserves are necessary to the functioning of a Class I market. Hence Dr. Ling correctly refers to them in a combined category of necessary reserves. Milk production above the level of necessary reserves are referred to by Dr. Ling as excess reserves. This term was used because Dr. Ling's study focused on the Class I market exclusively. In reality, excess reserves are the milk supplies that are, for the most part, a crucial part of manufacturing sector in the Northeast. Most of these "excess reserves" go to Class III cheese uses. However those excess reserves are not a factor in Dr. Ling's study nor in the ADCNE proposal. All of Dr. Ling's costs factors involve necessary reserves for the Class I market.

Further testimony by Mr. Dennis Schad will document the reasons why we believe that the Northeast market conditions warrant the use of a 20% operating reserve as discussed in Tables 4 and 5 of Dr. Ling's report (Exhibit \_\_\_\_\_).

Figure 1 in Dr. Ling's report, Exhibit \_\_\_\_\_ contains a tremendous amount of information. The key numbers however are the seasonal, operating and necessary reserves. Figure 7 isolates those amounts. The operating reserve in Figure 7 is the area between the seasonal and necessary reserves. The key issue here is the large amount of reserves needed and their volatility.

Dr. Ling's cost estimates are conservative. When he considers the balancing costs of handling the reserve supply, he assumes a costs of 28 million dollars for a butter-powder plant with a capacity of manufacturing 3 million pounds of milk per day. In 1999 we looked at relocating our West Springfield plant and estimated a costs of \$33 million if we moved much of the equipment to the new location. If we provided for new equipment, the cost would approach \$40 million. Dr. Ling also estimates total fixed and overhead costs at about \$3 million. Total fixed and overhead costs at our West Springfield plant are in excess of \$4 million per year.

Dr. Ling uses an estimate that for every 1 -percent decrease in the plant capacity use, product costs will increase one-tenth of a cent per pound. Our costs at our West Springfield facility increase slightly over that amount, approximately .11 cents per pound.

Based on our information, we believe that Dr. Ling's estimated cost of balancing necessary reserves assuming 20 percent operating reserves (his Table 5), are low and therefore conservative. We are not suggesting adjusting his estimates since each plant is different and the department has consistently leaned to conservative estimates in the past.

#### **WHY CAN'T WE RECOUP THOSE COSTS FROM THE MARKETPLACE. WHY DO WE NEED TO GO TO THE ORDER TO GET THE JOB DONE?**

Cooperatives who balance the Class I market have been unable to recoup the costs of balancing these markets. Class I processors will not pay any more than they have to obtain a milk supply and many believe that they pay a higher enough price with the Class I differential, particularly after Option I a became effective in place of the recommended Option Ib on January 1, 2000.

As already expressed by Mr. Gallagher in his testimony and touched upon by mine, Class I processors have alternatives to procuring their milk from cooperatives. There are more than 4,000 nonmembers in the regions and those producers supply more milk than is even pooled in several Orders. Class I processors can balance their seasonal needs by adding or dropping producers when needed. This is what occurred prior to the AMAA of 1937. It created disorderly marketing as it then would again. However even if processors behave in that manner, it would merely shift the burden within the marketplace and the costs would still exist.

One of the greatest problems we face in this industry is that dairy price setting is extremely sensitive to the last hundredweight of milk on the market. If that milk does not have a willing home, it will depress all milk prices, both over-order and class price.

We see this both national and regionally when current milk production is just over 2 percent above a year ago in a market facing stagnant demand. At most, the supply/demand situation reflects from two to five percent more milk and milk products than last year. Yet milk prices have fallen more than 25% as those additional supplies of milk and dairy products have sought a home.

Federal order prices are specifically meant to be minimum prices. When small amounts of milk are without a home, any existing over-order price is the first to go. Class I prices are set nationally but if no one was willing to provide a ready home for the milk, that milk is sold below the class price. The only thing worse than a low price for milk is no price for milk. Cooperatives provide a home and protect the integrity of class prices to the greatest degree possible. All producers benefit from this orderly marketing.

If not for the investments that Agri-Mark members have made in areas other than balancing, our members could face reblends on a regular basis. We keep our members well informed concerning Order minimum prices and any deviation from the minimum blend would be noticed immediately.

**WHY HAVE COOPERATIVES DONE BALANCING IN THE PAST AND WHY DO WE NEED REIMBURSEMENT OF THOSE COSTS FROM THE ORDER NOW?**

Cooperatives have balanced in the past because it helped create an orderly marketing environment that allow us to sell milk at or above Federal Order minimums. Our members did benefit from that action, but that benefit came with a costs that was not shared equitable with farmers in the Order who incurred no balancing costs. In 1985, Congress passed the Food Security Act of 1985 that specifically allowed for marketwide service payments. These service payments were first sought by Dairymen, Inc., the largest cooperative serving seven southeast Federal Orders involved in the hearing.

Marketwide service payments were denied to those seven orders because substantial volumes of milk moved between those relatively small orders as well as nearby orders. There was no way to assure that the producers in one order would not pay more than their share of balancing other orders. Equitable sharing of costs was the problem issue and, according to USDA's findings and conclusions, "so pervades (that) proceeding that it (was) concluded that further consideration of the proposals would serve no purpose" (Fed. Register, Vol. 52, No.84/ May 1, 1987, p. 15959.)

Proposal 7 differs from the marketwide service proposal made for the seven Southeast Orders in many regards. However the primary difference is in regard to size and marketing characteristics of the Northeast Order. The Northeast Order is one extremely large market that is far more regional contained than the southeast orders were in 1986.

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In fact, the current Northeast order is not only the largest Federal order in terms of both producer receipts and class I sales as noted by Mr. Gallagher, it is larger than all of the former seven southeast orders combined. There is relatively very little movement of milk between the Northeast and other orders on a percentage basis.

From the late 1950's until January 2000, cooperative service payments existed in the New York-New Jersey Federal Order. Agri-Mark and other cooperatives, that operated in the Northeast, but not in the NY-NJ Order, regularly discussed getting marketwide payments, but cooperatives in the region could not agree on a way to proceed. We did all agree to seek them as part of FAIR act process that merged the Orders, effective on January 1, 2000. However, the Department denied our request.

In addition to cooperative payments in the former NY-NJ Order, we also had seasonal price adjusters in all three Northeast Orders that lowered the Class III and IV prices in the spring and raised them in the fall. This reduced our balancing costs by a small degree. However, other organizations did not see the same benefits and the Department denied them.

### **THE SPECIFICS OF THE ADCNE PROPOSAL**

Under proposal 1, qualifying organizations performing marketwide services of balancing the Class I market would receive \$.06 per hundredweight on qualified milk volumes which they pool. Each month the Market Administrator would make payments from the producer settlement fund. Both cooperatives and proprietary handlers who performed these duties would be eligible for payments.

The \$.06 per hundredweight rate was determined using Dr. Ling's cost of balancing for the Northeast. At a 20% operating reserve rate, total balancing costs, on a conservative basis are estimated to be \$11,567,210. Cooperatives and other handler who provide balancing have approximately 76% (Market Administrator exhibit \_\_\_\_\_, appendix 17) of total producer receipts of about 24.5 billion pounds of milk annually (page 5 of same exhibit). This represents about 18.6 billion pounds of milk annually. When one divides Ling's costs by this milk volumes, it results in a rate of \$.0622 per hundredweight.

In order to qualify for payments, a handler would be required to (1) pool 3% of the market's milk OR (2) pool 1 million pounds of milk per day AND operate a pool manufacturing plant (Class III or IV) located in the states of the marketing area or a pool distributing plant as defined in section 7(a) of the Northeast order. These percentages and volumes of milk are supported as minimums because any handler, cooperative or otherwise, who balances milk on a daily and seasonally basis must have sufficient volumes and non-class I destinations for milk in order to meet market needs. A 3% minimum of the total volume pooled in the order for the month represents about 60 million pounds of milk per month. This handler must have significant marketing relations will at least one manufacturing plant plus a class I plant since it must move at least 20% of that volume, or 12 million pounds per month, at class I milk in the fall. Handlers who operate class III or class IV plants and pool milk can qualify at a lesser milk volume of one million pounds of milk per day, each month. This million pound per

day minimum was used in the cooperative payment provisions of the former NY-NJ order. It also represents about 20 loads of milk per day, which is a significant volume also.

Under subsection (a)(2) of the provisions of proposal 7, a qualifying handler could not deliver more than 65% of its pooled milk to a distributing plant. A handler who delivers 65% or more of its milk to a Class I plant is not balancing to a great degree. That milk is likely coming from a dedicated source of nonmember producers as already discussed in my testimony. Adjustments (a) and (b) are included to limit the ability of a handler to merely move milk around to qualify for payments without balancing those supplies.

Under subsection (b), the qualifying handler could be required by the market administrator to ship extra volumes of milk to Class I plants if market conditions warranted. Such extra shipments would not necessarily be required of other handler pooled in the Northeast order. Qualifying handlers who receive a marketwide balancing payment should be willing to take on additional responsibilities and additional costs when needed by the market.

The rate of the payments in subsection (c ) was previously discussed. Under this section, cooperative can only receive payments on the milk of their members or the members of another qualified cooperative association. Non-cooperative handlers can only receive payments on non-member milk that they pool. This will assist with accounting from the market administrator perspective and assure that the milk receiving payments is under the marketing control of the handler receiving payment.

We would like to add a provision at the end of subsection (c ) that modifies our proposal and reads as follows: "Provided further that no payment shall be made on the milk of any producer until such producers milk has been pooled for three consecutive months." The intent of this provision is to assure that any milk receiving a marketwide service payment is committed to serving the Northeast market. Milk that is moved to another market on a seasonal basis would have a waiting period before qualifying for a marketwide service payment. This provision further addresses the primary problem issue faced in the former southeast orders in 1986.

## **SUMMARY**

Large Class I markets such as in the Northeast require a substantial amount of balancing that benefits all producers. There is no question that balancing is needed given the pattern of class I demand and sales as well as the pattern of producer receipts during the course of the year and even with a week. There should also be no questions as to who performs the balancing and that there is a cost to that important service. Finally, there is also no question that the payment of marketwide services from the pool is allowed under the Agricultural Agreement Act of 1937 and its subsequent amendments.

The key issues the proponents of Proposal 7 is that the economic return for providing milk under the Northeast Federal Order for producer members of cooperatives who

balance the Class I market is less than that of producers who do not participate in providing those balancing services.

There have been problems in the past when considering marketwide service payments. Prior to January 1, 2000, there were three Federal Orders with a combined marketing area less than the one Northeast order has today. Although the issue of producer equity between orders was not as significant as in the former southeast orders, it still was a factor. A second issue was that the largest former order in the Northeast, the NY-NJ Order, had provisions known as cooperative service payments that was linked to balancing.

The consolidation and expansion of the three former orders in the Northeast into the largest Federal Order in the country addressed the producer equity issues between Orders. Although the cooperatives both inside and outside of the NY.-NJ order all supported the continuation and expansion of cooperative payments in the new order, the decision by the Department to not include those provisions pushed the cooperatives into working closely together to develop a fair and workable marketwide service proposal.

Plants which perform significant Class I balancing functions also perform many other functions. Isolating plant and other costs that specifically relate to Class I balancing would be extremely difficult. Many times the costs associated with balancing relate to not having milk and it is difficult to propose a payment on milk that is not in one's plant. Dr. Ling's study provided a way to isolate and quantify the costs using real world data and a low-cost, high economic efficiency approach.

The Class I market is different in the Northeast from all other markets. It is the largest in terms of both Class I sales volume and producer receipts. However the Northeast order also has more than 4,000 non-member producers that ship almost exclusively to Class I distributing plants. The Order also has more than 70 cooperatives of all sizes that compete in the marketplace to sell their members' milk.

Handlers, such as cooperatives that balance Class I needs, are unable to get reimbursed for the full costs of balancing due to competition in the marketplace among alternative supplies of milk available to Class I distributors. Class I distributors already pay one of the highest Class I differentials in the Order system and often consider those higher prices as covering the costs of providing milk to the Class I market, both as an aggregate supply and time sensitive supply. To the extent that the Class I differential is meant to encourage a supply of milk to the Class I market, there is already revenue in the pool relating to that function. However that revenue is distributed to all producers equally even though it is not the individual producer who balances the Class I market. That revenue should go to the groups that actually perform the services that benefit the market.

The Association of Dairy Cooperatives of the Northeast (ADCNE) proposal calls for a six cent per hundredweight payment to those producers who balance the class I market. It would be available to both cooperatives and proprietary handler who qualify. The proposal provisions provide adequate criteria for qualification so that payment only goes to handlers who truly balance the Class I market. Handlers who receive this payment

will be required to have additional responsibilities under the Order relative to serving the Class I market when needed. ADCNE has also proposed a provision that mandates a three month waiting period before producer milk will qualify for the six cent per hundredweight payment. This additional provision assures that qualifying producer milk is dedicated to serving the Northeast market on a consistent basis.

We ask that the Department implement proposal 7 as soon as possible.

Thank you.