

**BEFORE THE UNITED STATES DEPARTMENT
OF AGRICULTURE
AGRICULTURAL MARKETING SERVICE**

In the Matter of :
Milk In The Northeast : **Docket Nos.:**
Marketing Area : **AO-14-A70 et al;**
 : **DA-02-01**
 :

Testimony of
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on behalf of the
Association of Dairy Cooperatives
in the Northeast

Proposal 7
(Part 2)

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Thank you for allowing me to return to testify further about the ADCNE marketwide services proposal.

A Brief History of Dairylea

Dairylea Cooperative's business operations can best be described as in a continuous process of evolution. Today's Dairylea is vastly different than it was 50 years ago, or even 5 years ago. Started in the early 1900's, it quickly became one of the largest dairy cooperatives in the Northeast, and in so doing, was involved in just about every milk processing and manufacturing operation known, at the time. Its members invested in, and management operated, hundreds of manufacturing, processing and county receiving stations throughout the Northeast.

Over time, Dairylea's results with operating plants were not good. In the early 1980's, Dairylea's members and management made the decision to exit from the management of operating plants. By the mid 1980's Dairylea accomplished this and set out on a new strategy of providing marketing, membership and on-farm services to its members. The history of Dairy Farmers of America's predecessor cooperatives in the Northeast, including Sheffield Farms and Eastern Milk Producers Cooperative, would be found to be very similar to Dairylea's.

The services oriented strategy has served Dairylea's members, customers and, in general, the Northeastern dairy industry well. Since 1990, Dairylea grew from marketing 1 billion pounds of milk annually, to its present size of marketing more than 5 billion pounds annually for more than 2,400 dairy farmer members. A strong proportion of this growth occurred by Dairylea's ability to get medium sized dairy cooperatives to join Dairylea as member cooperatives. This allowed those cooperatives to enjoy the milk marketing and member services benefits of a large cooperative, and at the same time keep their culture, local presence and private governance.

Today, Hoard's Dairymen ranks Dairylea the 5th largest dairy cooperative in the United States.

The DFA Joint Venture and Dairy Marketing Services

In 1999, Dairylea's business evolved further when it entered into a joint milk marketing and membership venture with Dairy Farmers of America and formed Dairy Marketing Services. Dairy Marketing Services, headquartered in Syracuse, NY, is responsible for the milk marketing and membership operations for Dairylea and the Northeast Council of Dairy Farmers of America.¹ Through the Dairylea and DFA relationships, DMS markets over 12 billion pounds of milk annually.

¹ The Northeast Area Council encompasses the geographic territory that includes New England, New York, New Jersey, the territory in Pennsylvania east of the Alleghany mountains, Maryland and Delaware. This region was the membership territory of the former Eastern Milk Producers Cooperative. In the early 1990's, Eastern merged into Milk Marketing, Inc. In the late 1990's, Milk Marketing, Inc was one of the founding cooperatives of Dairy Farmers of America.

Although the Dairylea and DFA members and member cooperatives make up the majority of the milk DMS markets, it has also forged marketing relationships with other cooperatives and independent handlers. In the case of the independent handlers, the milk marketing and payroll functions have been, or are in the process of being outsourced to DMS who will provide these services to the particular independent dairy farmers.

DMS markets, on average, 650 loads of milk per day to more than 100 milk plant locations for over 7,000 dairy farmers. A significant number of these plants package fluid milk for route delivery. DMS sells more milk to Class I distributing plants in the Northeast than any other business.

The DMS marketing scope and breadth cuts across every region of the Northeastern US – the only such milk marketing business in the region that does so. It supplies Class I plants in Maine and manufacturing facilities in western New York. It delivers milk to Class I facilities serving Boston, Connecticut, New York City, Northern New Jersey, Philadelphia, Harrisburg, Baltimore and Washington, D.C. It also serves Class I customers with sales in Scranton, Binghamton, Rochester, Syracuse, Utica, Albany, Springfield, MA and points in between. Additionally, DMS supplies manufacturing plants from northern Vermont and New York south to Maryland and from Central Massachusetts, west to northeastern Ohio.

The DMS Milk Balancing Operations

For its size and scope, DMS balances its milk differently than most cooperative organizations in the country. Where many cooperatives rely on cooperative-owned balancing plants to be the primary process of balancing milk supplies, DMS does not do this necessarily. Instead, DMS employs a strategy of balancing milk at the region's manufacturing plants, most of which are not owned or operated by DMS, Dairylea or DFA. In fact, DMS has no ownership interests in plants, while Dairylea has minimal interests. DFA has more substantial balancing-plant ownership interests than Dairylea.

Dairylea is one of three cooperative owners of O-AT-KA Cooperative, the butter/powder and specialty products plant located in the western NY town of Batavia. DFA is the owner of two powder and specialty product facilities under the name of Dietrich's Milk Products, LLC.² One plant is located in the southeastern Pennsylvania city of Reading, while the other is located in the northern tier of Pennsylvania in a town called Middlebury Center. Although DFA owns a large cheese plant in western Pennsylvania, Farmers Cheese, the proximity of it to the east coast's metropolis and its important Class I processing businesses, makes it of limited use to balancing the DMS and Order 1 market's daily and weekly Class I and overall producer needs. However, it is utilized as one of a number of plants to help balance seasonal and holiday surpluses.

² Until just recently, Dietrich's Milk Products, LLC was equally and jointly owned by DFA, Dairylea and the Dietrich's family. This three-way ownership began in 1999. Although Dairylea is no longer an owner in Dietrich's, the balancing costs associated with these plants are still shared between Dairylea and DFA. In essence, DFA owns and operates the plants on behalf of DMS. DMS is charged Dietrich's balancing costs. In turn, via a proprietary formula, DMS passes those costs along to its owners, Dairylea and DFA.

The Portfolio Balancing Strategy

DMS follows a balancing strategy developed previously by its member owners, Dairylea and DFA and DFA's predecessor organizations here in the Northeast. This strategy uses a portfolio approach to balancing member and customer milk needs. The portfolio is made up of every manufacturing customer in the Northeast including the three plants fully or jointly owned by DFA or Dairylea. The portfolio approach reduces members' risks by:

- ❖ limiting their investments in the cooperatives, allowing their members to have a greater share of their farm's equity available to them to do as they wish,
- ❖ attempting to optimize the use of existing plant capacity,
- ❖ supporting the business operations of the region's manufacturing plants owned by others, providing such operations additional volumes of milk to help them grow their businesses and reduce their operating risks, and, above all,
- ❖ mitigating the costs of balancing the region's milk supplies.

“Renting” Balancing Space

In its simplest form, there is a “facilities” cost of balancing. Many cooperatives balancing costs come through the process of owning facilities. These costs are incurred either through the costs of operating plants or through the costs of carrying the plant asset in the fall months and at other times of the year when the plant is significantly underutilized or idle. When using other businesses facilities to balance, this cost, in one form or another, can be boiled down to the market cost of renting balancing space. The DMS portfolio approach relies both on “rented” space, as well as owned space.

Others testifying on behalf of ADCNE will spend more time discussing the costs of owning balancing space. I want to spend a little time discussing the costs of “renting” balancing space.

My use of the term “renting” balancing space is an economic term. There is no actual process that I am aware of that involves a rental agreement or lease to avail a cooperative of space at a manufacturing plant to balance their member and customer milk needs. However, there are “real” costs that do exist. These real costs are, in a sense, rental payments for plant space.

Rental Balancing Cost: Under Class Pricing

The following identifies a real world cost of renting balancing space by using a more commonly referred to term: under class pricing. To help illustrate this cost, take, for example a load of milk that is delivered to a pool distributing plant on an every other

day basis (recognizing that most producers are picked up every other day) with the exception of the weekend when the Class I processor is limiting its intake of milk.

As was described in earlier testimony, DMS is a co-operator of the milk grid and, in so doing, assures that all milk produced finds a plant demand point, even if the normal plant demand point, in this example the Class I processor, chooses to reduce its purchases. As part of this service, DMS finds a manufacturing plant willing to take the load not needed by the distributing plant.

The economic return on this particular load is different than on milk delivered to the manufacturing plant on a regular basis. Here is why. Manufacturing customers contract with DMS for a given amount of milk per week, month or year. A price is set for these “regular” deliveries that is based on Class price plus handling charges. The pricing on regular deliveries, which are loads of milk that land at the manufacturing plant consistently throughout the year, is determined in advance of the milk being produced and is based on “generally existing” market conditions. Generally existing market conditions can be described as milk being long in the flush and short in the fall, but that the market for the year is not excessively long or excessively short. The Class-plus handling charge price holds throughout the year, unless an excessive milk condition occurs.³ When a “balancing” load becomes available, such load generally falls outside of the contract’s pricing. In such a case, the load is priced on the “spot” market – determined by that particular day’s supply and demand dynamics.

These loads also carry another demand characteristic that undermines the load’s value. I call this, for lack of appropriate economic term, “opportunistic” pricing. Let me explain.

When a manufacturer is offered a load of milk being balanced back from a Class I source, the manufacturing operator knows, based on the interactions of the dispatching and receiving processes, that the milk is normally delivered to Class I, isn’t needed by Class I, and is in search of a delivery location. When this milk is offered to the manufacturer, the plant operator knows he can buy the milk at a discount to its normal class plus handling price. The manufacturing plant knows this since DMS has to land that load quickly due to milk’s perishability, its inability to be inventoried on a truck, and the need for the truck and trailer to be ready to meet its demanding schedule of picking up its next load milk on the farms. Generally, no matter if milk is excessively “long” or really “short”, balancing loads do not return the same price to the cooperatives as do regular deliveries. And, during the flush and other times, these loads generally are priced at Class price minus.

If the weekend load was delivered to the manufacturing plant during the flush season, it would likely be priced at a discount to the Class price since that is likely where

³ Under excessive milk conditions, regular loads are still priced at Class, but the handling charge is adjusted to reflect the excessive condition – meaning higher handling charges when milk is excessively short and vice-versa.

the spot market – that day’s supply and demand interaction - would be that determines the “clearing” price for milk. Since DMS settles with the Order at the value of the Class price and the producers get paid the “blend” plus premiums – as dictated by competitive market dynamics, the under Class price discount is a real business cost involved in balancing milk supplies.

This type of cost would not be associated with just the weekend balancing loads. These dynamics and their associated costs have the potential to be involved with the balancing of all necessary milk supplies, as defined by Dr. Ling – especially during the flush and around holidays.

This same cost is generally incurred when milk is “turned back” during the week. A “turned back” load refers to a load that is ordered by a Class I customer at the beginning of the week based on that customer’s anticipated milk processing needs for the week. As the week goes by, the processor recognizes it has over ordered because its supermarket customers’ orders aren’t as brisk or it is receiving more milk than anticipated by its independent producer or cooperative supplies. When this occurs, the Class I customer notifies DMS that it is cutting back orders, and in effect, has DMS balance its Class I needs as opposed to asking its own independent shippers to balance its needs. Economics on the delivery of this milk, relative to the under class pricing “rental” balancing cost, is quite the same as that explained in the previous scenario.⁴

Rental Balancing Cost: Lost Handling

Another rental price is the cost of lost handling on balancing loads. In many cases, the weekend balancing milk carries a reduced or, in some cases, no handling charge for the sale. Again, this is for the same reasons as described in the under Class pricing discussion about spot milk and “opportunity” pricing. Since the producers will still be paid premiums for their milk on the load, regardless of whether or not it is balancing milk, the cost of foregone handling to cover the premiums paid to the producers becomes a real business cost. Although I do not know the count, more loads of milk are sold at reduced or no handling than at under class pricing. All loads sold under class are sold at zero handling.

Under class pricing and lost handling charges are balancing costs associated with maintaining the necessary reserve supply of milk to meet our Class I customers fluctuating daily, weekly, seasonal and holiday demands. For instance, an every other day pickup route that is delivered to a Class I processor once or twice during the fall, but isn’t needed by the Class I processor in the spring flush, can’t gain the same economic return at manufacturing plants as it can at Class I plants. Since the route isn’t available to the manufacturing customer on a regular basis, the manufacturing customer, who has made

⁴ From time to time and with some Class I customers, a turn back fee can be charged in these instances. However, the ability to utilize turn back fees is very limited to certain customer situations, only applies to milk loads ordered and then cancelled during a week, and during the flush, the turn back fees generally only mitigate a portion of the balancing costs on a turned back load.

other plans to meet its milk supply needs, isn't willing to pay as much for milk that only sometimes shows up at his plant.⁵

Certainly one can see the different economic position a "balancing" load of milk is under, not only on weekends but at other times as well. For instance, an unfavorable economic position occurs when balancing the seasonal surplus during the flush, when schools aren't in session, on holidays or the week leading up to Christmas or New Year's Day.

Also, Tolling Costs

Balancing Cost: Unreimbursed Delivery Costs

Not all balancing costs are incurred when "renting space" or operating plants. A particular cost incurred by those co-operating the milk balancing grid is common to all, whether they are renting space or operating plants. This particular real world balancing cost occurs when there are unreimbursed delivery costs associated with diverting milk to a manufacturing plant from its usual home at a distributing plant.

Dairyalea and DFA member pay programs have evolved into something more like farm point pricing than plant point pricing. This has occurred due to our reactions to the market place as opposed to a strategy to set us apart from the market place. Written another way, competitive market dynamics have dictated this pricing mechanism. By farm point pricing I mean, that a member, more often than not, is assigned a producer price differential zone for his/her area or based on a local manufacturing plant – regardless of whether the member's milk is delivered 240 or so miles to a distributing plant, or 30 miles to a manufacturing plant. Similarly, the hauling charge to members is designed to cover most of the cost of delivering milk locally, thus corresponding to the zone of the producer price differential.

For most deliveries of milk from, say Central New York and Northern Pennsylvania in towards the cities, the higher city zones, generally, cover most of the additional cost of moving the milk from "up country" to the Eastern Seaboard cities. This generally occurs even though the zone differences between manufacturing areas and the major Class I consumption areas were narrowed during Federal Order reform. Producers that deliver to a distributing plant a majority of the time, if they are under a "local" pay price program, generally have any portion of the hauling cost, not covered by zone, added to their hauling charge that shows up on their milk check. Generally this is the case if the local procurement area's supply and demand situation allows these costs to be passed along. This is not always the case. Especially in areas where proprietary Class I plants, with their own producer supplies, are actively soliciting milk.

⁵ In fairness to our manufacturing customers, they can't afford to pay full price for this milk. These customers have already made plans to sell their production from their regular deliveries. Generally, their customers do not need any more product so aren't necessarily willing to buy additional product unless there is a clear price discount available. Likely, these manufacturing plants would not purchase the milk if they didn't have a sale because of the high risks and costs of inventorying and hoping to develop a sale. Therefore, these manufacturing customers are only willing to purchase additional product if the price is discounted enough to help the manufacturer move the product to one of their customers, relatively quickly.

In general, the economics of delivering milk to the Class I market, on a regular basis, from normal supply areas, say 240 miles and in to the metro New York area and Boston, result in the milk landing in, say Northern New Jersey, with no or little extra cost to the dairy cooperative. This means that the “net” of the producer price differential paid to the cooperative and the hauling cost it bears for delivering the milk to the distributing plant, match the producer price differential paid to the producers and the hauling charges they are assessed.

There is a significant daily and weekly variation in raw milk demand at distributing plants, as explained by Bob Wellington and alluded to in my previous testimony. Although loads of milk, made up of the milk production of a number of Dairylea and DFA farms, may be delivered to a distributing plant a majority of the time, it is very rare for these loads to be delivered to a distributing plant all the time.⁶ When this milk isn’t delivered to an eastern seaboard distributing plant, but instead is delivered to a manufacturing plant, the net of zones and hauls for the manufacturing plant delivery do not always net to zero.

This means that the producer price differential received for the load and the hauling cost for delivering the load do not match the producer price differential paid to the producer or the hauling charge extracted from the producer. When this doesn’t net to zero, it results in a cost to be borne by the cooperative.⁷ Thus, another “real” balancing cost is incurred when milk is diverted from its regular distributing plant destination and the economics of the plant zone and hauling charge of the plant receiving the diversion do not net the same value as the normal distributing plant delivery.

These costs are even greater when the balancing plant is in a lower zone than that which the producer is paid. For example, during the spring flush, it is not uncommon to move milk, usually delivered to distributing plants in metro New York, to O-AT-KA. The producer pay program would be set up so that on the deliveries to NYC the net of the producer price differentials and hauling charges collected and paid are zero. Thus, the economic analysis of any net impact to a cooperative that balances this milk would be a straight up comparison between zones and hauling charges for the two alternative destinations.

Exhibit 19, Table 1 depicts the economics of a real world balancing milk movement. It shows that the zone for the Dean Foods plant known as Tuscan Farms in Union, New Jersey is Boston (the zero-zone) minus \$0.10 and the zone at O-AT-KA is Boston minus \$1.05. When this balancing movement occurs, the cooperative is out \$0.95 in zone. Since the distance between Central NY (for example the Cayuga County town of Locke, NY) and O-AT-KA is less than the distance between Central NY and Tuscan

⁶ This is unlike individual producers or small cooperatives procured by a proprietary Class I distributing plant. For these producers, their milk is delivered to the Class I plant every single day with very few exceptions.

⁷ It is the very rare case when the net results in a gain to the cooperative.

Farms, the O-AT-KA delivery's hauling cost is less. For the Tuscan delivery, the hauling charge is \$1.19 per hundredweight, and for the O-AT-KA delivery, the hauling charge is \$.75 per hundredweight. This results in a \$0.44 hauling savings to the cooperative. Unfortunately, the savings in hauling costs does not match the loss of income in zones. Thus, the cooperative registers a real world balancing cost of \$0.51 per hundredweight on this movement. This cost is on top of any lost handling and under class pricing that may also be incurred.

Balancing Costs Include Balancing "In"

Balancing the markets need isn't just handling Class I's operational reserves, milk that is turned back from Class I, or is seasonally long, it is also providing milk to Class I in the fall, or other times, when the milk supply is tighter. Upon review of Dairylea's Federal Order Reform comments, you will be reminded that Dairylea was a proponent of a narrowing of the zone differences and flattening them in western and northern New York. This was requested, in part, to prevent further erosion of blend prices for the sole purpose of assuring that the higher hauling costs of supplemental milk from distant manufacturing areas would move milk to Class I on the few occasions it was needed. It was also requested as a means of mitigating the balancing costs described in the previous section.⁸

Instead, Dairylea pointed out, it would be better to maintain stronger blend prices by having flatter zones in the outer areas of the milk shed where the Northeast's milk production sector is growing and becoming more and more relied upon to fill the needs of the Federal Order 1 Class I market.⁹ Most of the milk in these outer areas is marketed by cooperatives. The milk that isn't marketed by cooperatives is controlled by proprietary plants that operate manufacturing plants.

Unfortunately, the market's competitive dynamics and the differences in zones between western and northern New York and the Class I plants along the eastern seaboard, do not allow for these costs to be recouped. Although the Secretary agreed with the suggestion of flatter zones, another element of the request, to have a marketwide services balancing payment program to compensate the cooperatives for their extra costs of moving milk from areas of supplemental supply to the Class I market, was not included.

Since Federal Order reform, the dairy cooperative members of DMS have taken on additional contractual obligations for supplying certain Class I customers with 100 percent of their milk needs. The Northeast market's competitive dynamics, discussed at

⁸ As the previous discussion illustrated, such costs are far from mitigated with the flatter pricing.

⁹ Although not shown, a review of production trends in the Northeast would show production declining in the traditional Class I procurement areas of Massachusetts, Connecticut, central New York and northern Pennsylvania. Alternatively, production is growing in northern and western New York. Going forward, milk produced in northern and western New York will take on increasing strategic importance in assuring that the Class I plants, serving the eastern seaboard cities, will be adequately supplied with milk.

this hearing, make it prohibitive to DMS to extract higher handling charges from these customers in order to cover these extra costs.

Again, Dairylea requests the inclusion of the proposed marketwide service program to compensate the dairy farmer members of Dairylea and DFA, as well as the other ADCNE members, for fulfilling the important functions they provide the Class I market and all Order No. 1 producers in their work to assure our Class I customers receive the milk they need, when the need it. Doing this maximizes the milk pooled in Class I and generates stronger producer price differentials for all producers.

Balancing at Dietrich's

Like the other members of ADCNE, DMS also balances milk through plants owned by one or both of the member-partners. As previously stated, Dietrich's Milk Products, LLC operates two pool manufacturing plants in Pennsylvania. One is in Reading and the other is in Middlebury Center.

The costs of operating these plants, and the associated balancing costs, have fallen back to Dairylea and DFA via a charge by Dietrich's to Dairy Marketing Services.

The plants primary purposes are to balance the Class I needs of DMS customers, and the Northeast milk market, in general. Both of these plants have been utilized as reserve balancing plants. Exhibit __, Table 2 shows the monthly plant receipts of milk and skim condensed from January 2000 through June 2002.

The Reading plant has operated continuously over this time period. However, the amount of milk it had available to process is as variable as the milk price. Please note four aspects:

- 1) Reading processes more milk in the spring,
- 2) it receive significantly reduced volumes in the fall,
- 3) 2001 deliveries were low most of the year, and,
- 4) it operates at less than full capacity most of the time.¹⁰

The operation of the Middlebury Center plant has been even more variable. In 2001, when milk production was tight, Middlebury did not take in any milk from August – November, and in 6 other months it received less than 5 million pounds.¹¹

Exhibit __, Figures 1 and 2 are two graphs that show the plant capacity utilization at each of the Dietrich's plants during this time period. The maximum capacity was determined based on the largest delivery to each plant in any month of the time period. These pictures graphically show the tremendous variability in milk receipts at balancing plants.

¹⁰ The maximum intake of milk during this period was 51.7 million pounds which occurred on two occasions. The plant's actual operating capacity is about 1.8 million pounds per day.

¹¹ Middlebury's operating capacity is about 1 million pounds per day.

There are significant costs of carrying an idle plant and operating plants at reduced capacity. During the 30 months shown, Middlebury operated at less than 50% capacity 16 months, more than 50 percent of the time, while Reading operated in such capacity during 8 months – more than 25 percent of the time. Although Reading was able to operate during each month of 2001, it did not receive milk every day of the week. Its main purpose during the late summer and fall months is to balance the weekend, holiday and daily milk needs of the region's Class I customers.

Although more milk is being delivered to these plants now, the flow of milk to them has not been constant. Again, more milk is delivered to them on weekends than during weekdays. Thus, some of the costs related to idle plants, or operating the plants at less than full capacity, still exist even though the plants are taking on significantly larger volumes of milk each month, and that on weekends, at least during the flush, have been operating at maximum capacity.

The tremendous variability in milk receipts has created the obvious costs associated with idle and under used plant capacity. It has also impinged on the plants' options of maximizing its revenue. Since the plant operators can't predict how much milk they will receive, or whether they will receive milk, it has become very difficult for them to win long term and steady contracts with users of milk powders. Kind of like how the US is viewed in international markets, Dietrich's is viewed domestically. Because of the unique structure of the Northeast market and Dietrich's role in balancing the Class I market, powder buyers do not rely on Dietrich's as a steady dependable supplier of product. Therefore, the buyers go elsewhere, or like the "opportunistic" balancing cost I described earlier, the buyers know that Dietrich's sales force is caught between a rock and a hard place and therefore aren't willing to, and don't need to, pay as competitive of a price for the Dietrich's powder.

The Dietrich plants have been extremely unprofitable to operate, as a result. However, due to the region's expanding milk production and the limited manufacturing capacity near the metro New York and mid-Atlantic area's Class I markets, the Dietrich's plants have been an integral and necessary part of the milk balancing grid. Closure of these plants, would have generated balancing costs in excess of the losses at Dietrich's. This result would have occurred since the existing plant capacity in the area would not have been able to absorb all of the milk that the Dietrich plants would have shed. With the resulting market pricing through the flush and the added hauling costs, the total costs of balancing the milk at the region's other manufacturing plants and at plants in distant markets, would have exceeded the costs in operating these plants.

Exhibit A, Table 3 depicts the DMS balancing costs for January-July 2002, by component, and for the entire year of 2001. To date for this calendar year, DMS has expended more than \$9.1 million dollars balancing the Northeast's milk markets. This cost is net of any turn back fees and any cost involved with balancing milk pooled on the

Southeast orders. This amounts to \$0.20 per hundredweight on the Dairylea and DFA-Northeast Area Council's member milk supplies through July.¹²

By component, DMS balancing costs include:

- \$4.9 million at Dietrich's¹³
- \$0.6 million of underclass pricing
- \$0.7 million of unreimbursed hauling, and
- \$2.8 million in lost handling charges.

For 2001, a year of very short milk supplies, DMS incurred balancing costs in excess of \$6.8 million dollars, which was almost \$.10 per hundredweight on member milk supplies.

During the 2001 Christmas season, DMS balanced 17.1 million pounds (342 loads) of milk over two weeks at a cost of \$520,000.

Dietrich's Costs vs. Ling Study

Both Dietrich's plants are significantly below the plant capacity of 3 million pounds per day that is used in the Ling study. Exhibit __, Figures 3 and 4 graphically show the monthly plant intakes at Reading and Middlebury Center vs. that derived from the four butter-powder plants in the Ling study. For instance, Figure 3 shows that in May, the Ling plants averaged taking in about 90 million pounds of milk per plant while Reading took in slightly more than half that amount in 2002 and less than half that amount in 2000 and 2001. The Middlebury Center plant did not receive any milk in August – November of 2001. The plant's in the Ling study always received milk equal to at about half their capacity during the fall months.

Due to the significantly smaller nature of the Dietrich's plants, relative to the Ling study, and the more variable nature of the milk receipts at the Dietrich's plants, their costs are significantly higher than the those costs illustrated in the Ling study, intuitively.

Balancing Plants and Marketwide Services Eligibility

Although both Dairylea and DFA have ownership interests in balancing operations, as do the other ADCNE members, the group advises against making non ownership of balancing facilities a prohibition for receiving marketwide service payments.

¹² On a full year's production, this will likely average about \$.12 per hundredweight.

¹³ Exhibit __, Table 4 gives an overview of the income statement categories for the Dietrich's plants. Costs associated with operating Dietrich's are the only costs included. No costs associated with DMS, DFA, Dairylea or any other entity are included. DMS is charged a monthly crossover "recharge" that covers the losses Dietrich's pays for milk, over and above what they can recoup from the market place given their operating profile.

There are many ways and different business philosophies surrounding the process of being a co-operator of the Order No. 1 milk balancing grid. For many years prior to the DMS joint venture and the affiliation with Dietrich's Milk Products, Dairylea's primary process of balancing milk was via "renting space" from its manufacturing customers. This process works in the heart of the DMS milk territory due to the significant abundance of proprietarily owned manufacturing plants throughout this region. Although the Dietrich's plants have taken on a bigger role in balancing DMS's milk marketing network, "renting space" from our customer still serves as a major part of our milk balancing portfolio.

Dairylea and DFA are constantly analyzing opportunities to help our customers grow and to better invest the equity of our members. It is not unrealistic to think that at some point in the future, Dairylea, DFA, DMS or even another ADCNE member will no longer be involved in operating or owning manufacturing facilities. Yet, even though this would occur, each organization would still be providing the service of balancing member's and others milk by "renting space".

A milk marketing business does not need to own a plant in order to balance milk. Additionally, making plant ownership a requirement for receiving marketwide services could force dairy farmers into investing in and maintaining outdated, small and inefficient manufacturing facilities. Additionally, it could result in unneeded plant capacity in the Northeast – putting at risk the ability of the region's current manufacturers to receive the milk supplies they need to grow their businesses in a manner that keeps them competitive with western US manufacturing operations. Forcing excess plant capacity could also create issues for distributing plants in their efforts to assure an adequate supply of milk for the public.

The important aspect isn't how milk is balanced; instead, it is how those that do the balancing can be compensated so that the farmers shipping to those co-operators of the milk grid aren't disadvantaged by the service they pay to have performed.

Market Competition Prohibits Voluntary Balancing Charges

Earlier in this proceeding I and others testified about the unique make up of the Northeast Order. Due to the Northeast's huge population base, which represents almost one-quarter of the US population, it has been able to attract and sustain a rich, dynamic and diverse dairy industry. In so doing, it is the largest Federal Order in that it pools more Class I, II and IV milk than any Federal Order in the country. Additionally, it is the fourth largest Class III order in the country. These characteristics create a market structure that is unique and requires, and justifies, marketing order provisions that are as well unique in order to resolve disorderly marketing conditions.

Of particular interest to ADCNE is the disorderly marketing condition that has essentially forced large dairy cooperatives to pay their members less than the minimum blend price due to their operation of the milk balancing grid that benefits all dairy

farmers, equally. Underlying this disorderly marketing condition, is the Northeast's unique market make up that has created a plethora of milk marketing opportunities for dairy farmers as evidenced by the 78 dairy cooperatives and 32 proprietary milk businesses that, every single, day compete against one another in the milk procurement arena.

I state again, a disorderly marketing condition exists in the Federal Order No. 1 area right now. This exists because cooperatives, via the financing of their members, operate the milk balancing grid and it is their members that shoulder the burden of carrying all of the costs of providing this service. This occurs, even though the balancing service provided by the cooperatives results in benefits to all producers.

These benefits include:

- higher producer price differentials, as a result of maximizing the amount of milk delivered to Class I processors for use in the highest price classification,
- greater stability in milk markets, since cooperatives provide the balancing cushion for Class I plant operators and thus eliminate the disorderly marketing condition that would result in its absence, that of Class I operators balancing their needs by dropping or adding producers as their seasonal needs changed,
- supporting a stronger and more dynamic dairy industry by providing a stable flow of milk to the region's milk plants thus reducing their risk of investment and providing all plants, either Class I or manufacturing, to thrive and grow and create steady and dependable markets for the regions' dairy farmers, and,
- support a system that creates an environment for stable and stronger voluntary milk premiums paid to producers.

Gallogher says impossible to quantify the \$ benefits to dairy farmers

Under current Federal Order market provisions, members of dairy cooperatives, who do the bulk of the balancing, are not receiving the same minimum Federal Order "blend" price as independent producers. Since these producers finance the cost of balancing the market and operating this grid, they, right off the bat, are placed in a worse position than those producers that do not ship to an organization that pools and balances milk. Since it is generally large dairy cooperatives that finance the milk balancing grid, it has placed their members a secondary position to non cooperative producers in the market relative to the sharing of Federal Order pools proceeds. This is unfair and our proposal recommends a solution that will help mitigate this inequity.

Conditions Exist for Emergency Action

The balancing costs of the ADCNE members are significant and burdensome. They result in a disorderly marketing condition in that those that are responsible to assure that the Class I distributors have fluid milk available at all times, and that process doesn't result in producers seasonally losing markets, are forced to pay their producers less than

the blend price. This not only puts at risk the ability of those that operate the milk balancing grid to continue to perform that function. If the co-operators of the grid stopped performing this function, chaos would ensue. The proponent cooperatives and their members can not go through another flush period without having this inequitable situation corrected. ADCNE strongly urges Dairy Division to have an emergency decision implemented on our marketwide services proposal. Please note, the following from the Act of March 20, 1986, P.L. 99-260, Section 9 part b:

“(b) Implementation. Not later than 120 days after a hearing is conducted under subsection (a), the Secretary shall implement, in accordance with the Agricultural Agreement Act ...a marketwide service payment program under section 8c(5)(J) of such act ...”

Again, thank you for allowing me the time to share this testimony with you, today.