

Exhibit _____
Federal Order Hearing, Week of May 4, 2009
Docket No. AO-14-A78, et al.
Testimony of Dr. Roger Cryan, National Milk Producers Federation
In support of Proposals 1, 2 and 26:
Eliminate the producer-handler provision;
Increase the limit for the size-based plant exemption;
And provide a qualified exemption for existing producer-handlers.

Introduction

My name is Roger Cryan. I have served the members of National Milk Producers Federation (NMPF) for the past nine years, first as Director of Economic Research, and now as Vice President for Milk Marketing and Economics. Prior to that, I worked in the Federal government as the economist in the Atlanta Milk Market Administrator's office of the USDA. I received my M.S. and Ph.D. degrees in agricultural economics from the University of Florida. I serve on the Agricultural Advisory Committee of the Commodity Futures Trading Commission and have served as a Secretarial appointee to USDA's Advisory Committee on Agricultural Statistics.

I testify today on behalf of the National Milk Producers Federation. NMPF is the voice of America's dairy farmers, representing three-fifths of America's 60,000 commercial dairy farmers through their membership in NMPF's 31 constituent cooperative associations. NMPF represents dairy farmers in all parts of the country, as demonstrated by the attached table, which shows NMPF's members among the top 50 U.S. dairy cooperatives (which *Hoard's Dairyman* ranked by volume).

NMPF is the proponent of proposals 1 and 2, which we submitted jointly with the International Dairy Foods Association. Those proposals initiated this proceeding. NMPF subsequently submitted an additional proposal, proposal 26, which we believe complements those initial proposals. These proposals are intended to establish more equitable rules for dairy farmers in all regions and of all sizes. The small and large producers who we represent, and the cooperative businesses that they operate, are required to play by one set of rules, while large producer-handlers are able to play by another set of rules that tilts the playing field greatly to their advantage. NMPF's three proposals, taken together, will result in the additional regulation of a very small number of handlers. We estimate that our proposals would increase the regulation for just 3 to 5 of the largest producer-handlers in the nation, all of whom have annual sales of at least \$10 million, at 2008 prices. We estimate that the 3 largest of these each have packaged fluid sales in excess of 15 million pounds per month. Our proposals would not increase regulation for any

other producers or processors. There are dozens of smaller exempt plants and producer-handlers that would remain unregulated or subject to less regulation.

I would like to describe each of our proposals, provide some historical context on the producer-handler provisions, and explain what we seek to achieve.

Proposal 1. Eliminate special status for producer-handlers.

NMPF seeks to eliminate the producer-handler provisions in all Federal orders, so that producer-handlers are treated like all other handlers. The Agricultural Marketing Agreement Act of 1937 specifically authorizes the regulation of “producers who are also handlers.” It is clear from the legislative history^{of} the legislation reauthorized by the Agricultural Marketing Agreement Act of 1937 that Congress intended for marketing agreement and marketing order programs to regulate producer-handlers whose volume “is large enough to be an important factor in the market,” since their “cooperation is necessary to carrying out the marketing plan.” (Amendments to Agricultural Marketing Agreement Act: Hearing before the Committee on Agriculture, House of Representatives, 74th Congress, First Session on HR 5585-Serial E; cited in mimeographed brief on authority to regulate producer-handlers.)

The Agricultural Marketing Agreement Act of 1937, as amended, 7 U.S.C. 608c(5)(C) provides:

“In order to accomplish the purposes set forth in paragraphs (A) and (B) of this subsection (5), providing a method for making adjustments in payments, as among handlers (*including producers who are also handlers*), to the end that the total sums paid by each handler shall equal the value of the milk purchases by him at the prices fixed in accordance with paragraph (A) hereof.” [Emphasis added.]

Treating producer-handlers like other handlers is equitable and consistent with the both the letter and the intent of the law.

Origin of Producer-Handler Regulation

Producer-handlers were originally given special status for administrative reasons, not on legal principles. The Federal milk marketing order program itself has its origins in the Agricultural Adjustment Act of 1933, which generally authorized the Secretary of Agriculture to enter into agreements with producers and to license handlers, in order to “restore normal economic conditions in the marketing of” milk and milk products. The Department combined these powers to implement marketing agreements

enforced by licensing in numerous markets. These licenses are the direct antecedents of today's milk marketing orders.

Although many markets were supplied primarily by handlers who procured milk from producers and cooperative associations, in the Kansas City market producers who handled their own milk sold 50% of the milk and cream consumed when the market's license was instituted in 1935. The original market license was intended to regulate these producer-handlers in the same way as other fluid milk handlers. However, the market administrator encountered considerable resistance from a substantial number of these producer-handlers who failed to submit reports and who refused to make payments to the equalization fund when they did submit reports. When the market administrator failed to enforce the market license requirements on the original non-compliers, most of the rest followed suit. Successive amendments to the marketing agreement were made to lessen the burden on producer-handlers, but again there was no effective enforcement, so non-compliance among producer-handlers with market license requirements proliferated. In July 1935, unable or unwilling to surmount the practical difficulties of enforcement, USDA abandoned its attempts to impose regulation on these producer-handlers except for certain reporting requirements. (See *Early Developments of Milk Marketing Plans in the Kansas City, Missouri, Area*. 1952; USDA.)¹

What began as an expedient way to avoid confrontation with a group of small producers in one marketing order has become institutionalized across the country. This largely unregulated status was, until recently, available to producer-handlers of all sizes in all Federal order markets.

¹ In May 1935 the Supreme Court invalidated the National Industrial Recovery Act for its overly broad delegation of Congressional authority to the executive branch (*A.L.A. Schechter Poultry Corp. v. United States*). The marketing agreement and licensing provisions of the Agricultural Adjustment Act of 1933 (PL 73-10) gave the President and Secretary of Agriculture similarly broad and ambiguous powers over agriculture. In August of 1935, to avoid the impact of the Schechter Poultry case, Congress amended this Act to codify the previous practices of the USDA, re-establishing the licensing of handlers as Federal milk marketing orders. (PL 74-320) Significantly, these 1935 amendments included language "providing a method for making adjustments in payments, as among handlers (including producers who are also handlers) to the end that the total sums paid by each handler shall equal the value of the milk purchased by him at prices fixed" by USDA. In other words, the regulation of producer-handlers was specifically authorized. After the Agricultural Adjustment Act of 1933 was invalidated in *United States v. Butler* (1936), this language was reenacted in the Agricultural Marketing Agreement Act of 1937 (PL 75-137), and has been retained to the present day (7 USC 608c(5)(c)), as part of a continuous system of milk marketing regulation; for example, the Central Federal Milk Marketing Order (7 CFR 1032) incorporated the Greater Kansas City Order, which had been continuously in force since its December 1936 establishment as the successor to the license discussed above. (See *Federal Milk Market Order Statistics Annual Summaries for 1999 & 2002*. USDA/AMS.)

Over the years, a number of milk marketing orders have incorporated a variety of producer-handler provisions, but the purpose of those provisions has been to require producer-handlers to nominally balance most of their own supply.

In 2003, proposals were made to limit the potential size of producer-handlers in the Arizona and Pacific Northwest markets. In 2005, those proposals were accepted by USDA, which issued a final rule in 2006 that limited the producer-handler provisions in those milk marketing orders to entities that produced no more than 3 million pounds of fluid milk sales per month. (71 FR 9430).

A Changing Industry

One of the original assumptions underlying the decision to permit a special producer-handler status was that these operators had limited supply and marketings, and would remain so small as to not have a significant effect on the market. Over time, this has proved to be a faulty assumption. Changes in the industry, in technology and in the economics of the dairy business have drastically reduced the number of producer-handlers; these same changes have drastically increased the size and market potential of those remaining. Some producer-handlers have grown to become much larger than could have been imagined 70 years ago.²

While most (87 out of 117) potential producer-handlers today still fall under the 150,000 pound size exemption, this is rapidly changing. (*Federal Milk Order Plant Structure Information for March 2009*) Until recently, the substantial growth in the scale and efficiency of large fluid milk processors meant that even the largest farms were unable to take advantage of the scale economies; with relatively high unit costs, producer-handlers did not proliferate, and in fact, they declined in number and volume processed.

But this is no longer the case. In 1998, there were only 235 dairy farms with more than 2000 cows; less than a decade later, in 2007, however, there were 595. A 2000-cow dairy produces nearly 4 million pounds per month. The average farm in this category produced 6.6 million pounds per month in 2007 (compared to 4.7 million in 1998). These 595 farms now produce over one-quarter of the U.S. milk supply, equal to nearly 80% of all sales of fluid milk products in the U.S. (*Milk Production*).

² In 1947, for example, four different Federal milk orders each pooled less than 3,000,000 pounds of producer milk per month. (*Federal Milk Order Market Statistics, 1947-56*. Agricultural Marketing Service, USDA. 1959.)

USDA/NASS, February 2000, February 2008; *Farms and Land in Farms*. USDA/NASS, February 2008; *Federal Milk Marketing Order Statistics 2007*, USDA/AMS.)

There are 17 producer-handlers with route sales in excess of 300,000 pounds, including only 7 with route sales above 2,000,000 pounds. (*Federal Milk Order Plant Structure Information for March 2009*. USDA/AMS, Exhibit ____) The average producer-handler has grown from an average of 34,645 pound of Class I sales in October 1959 (production from about 60 cows at that time) to an average of 1,422,080 pounds in December 2008 (milk from about 720 cows).(*Information on Producer-Handlers Operating in Federal Milk Order Marketing Areas*. USDA/AMS, Exhibit ____) We estimate the sales of the 7 largest producer-handlers to average at least 100 million pounds per year per plant.

Many dairy farms are now large enough to exploit both the producer-handler raw milk price advantage, which I will describe below, and to enjoy economies of scale in both milk production and fluid milk processing. Collectively, they could capture a large share of the Class I sales in an individual market or nationally, if many of them adopted this model. This would be disastrous for small pooled dairy producers whose blend prices would be substantially cut.

The hearing on producer handlers in the Arizona and Pacific Northwest markets demonstrated the potential disruption that large producer-handlers can inflict, individually and collectively, on orderly marketing, finding specifically that large producer-handlers in those markets were “the primary source of disruption to orderly marketing of milk.” (70 FR 74186) Producer-handlers also have a significant and growing share of Class I sales in the Northeast market; this was 114 million pounds in 2007, up from 69 million pounds in 2002. (*Market Administrator’s Bulletin*, April 2008. p. 2) This is the only market for which such a breakout is readily available; I estimate that the market share of producer-handlers in the Central order is equal to between 10% and 15% of Class I sales in that market.³ USDA data presented at this hearing also show that producer-handlers make up a growing share of sales in market where they are

³ Total Class I sales in F.O. 32 averaged about 360 million pounds per month in 2007. An article on the website of the Daily Oklahoman, published in Oklahoma City, Oklahoma, identifies Braum’s as milking 10,600 cows, which at the average per cow production for Oklahoma would produce 14.7 million pounds per month. (<http://newsok.com/faced-with-cost-increases-dairy-will-focus-on-quality/article/3361870>) Aurora Dairy’s website (<http://www.auroraorganic.com/aodweb/site/documents/AODOrganicStewardshipReport042008.pdf>) indicates that Aurora milks 12,290 cows, which would be expected to produce at least 16.9 million pounds per month. According to its websites (<http://www.heartlandcreamery.com/> and <http://www.sharpeholdingsinc.com/dairy.html>) Heartland

present and unaffected by recent restrictions. (*Annual Route Sales by Handler Type: Eight Orders for 2002 and 2006-2008*. USDA/AMS, Exhibit ____)

The Cost Advantage of Producer-Handlers and Uneconomic Re-organization.

A producer-handler, by avoiding full Federal order regulation as a distributing plant, can pay, effectively, the uniform price for milk at the plant. (This is effectively the market price for producer milk on the market, and is therefore the appropriate transfer price for analysis of the regulatory impact on the producer handler plant.) Fully regulated competitors, by contrast, must pay the Class I price for the same milk. Table 1 shows selected statistics for all Federal order markets, including a calculation of the price advantage that a producer-handler has over its fully regulated competitors in each market. That advantage is equal to the Class I price minus the uniform price. This advantage ranges from 6¢ to 15¢ per gallon, or 72¢ to \$1.74 per hundredweight. (The difference between the Class I price and the uniform price at the base point will equal the difference between Class I and the uniform price across the market, since both are adjusted by the same location differential.)

As producer-handlers become large enough, their advantage in terms of their cost of milk can become the primary basis for their existence as handlers. A large producer-handler can now enter the bottling business, even if it is not competitive in its processing costs, purely because the disparity in the regulatory scheme creates an advantage.

Increasingly, producer-handler provisions undermine the principles of producer equity upon which the Federal order system rests. In the best case (vertical integration of efficient milk production with efficient milk processing), the producer pool is depleted to pay producer-handlers. In the worst case (uneconomic reorganization of farms into producer-handlers), the current system creates deadweight losses in the market whose whole cost is borne by pooled producers. For example, a producer-handler could be up to 15¢ per gallon less efficient than the competition would otherwise require, and still be viable.

Orderly Marketing.

Dairy milks 4,500 cows and can generate 24,000 gallons per day per 3,000 cows, which would be 36,000 gallons per day from 4,500 cows, or 9.3 million pounds per month. All these sites were accessed on May 2, 2009.

Producer-handler provisions increasingly threaten orderly marketing. As stated above, about 600 farms now each produce more than with 4 million pounds of milk per month, 25% of the U.S. milk supply and the equivalent of 80% of U.S. fluid milk sales. 1500 farms with over 2 million pounds of monthly milk production account for 42% of U.S. production, equivalent to 140% of total fluid sales. The number of large farms is steadily increasing, and their impact on other dairy farmers is becoming more significant. Because of the potential for these large farms to exploit the advantages of the current producer-handler provisions, tens of thousands of smaller dairy farms, and the handlers who purchase their milk, are now potentially threatened.

Further, such producer-handlers, even if they bottle all of their milk and buy or sell no one else's, can sell to wholesalers or large retail chains at a significant price advantage. Such wholesalers or retailers can either balance their own supplies of milk, with purchases from, and at the expense of, pooled market participants; or they can raise and lower their prices seasonally, so that consumers will balance their supply at other stores, also at the expense of pooled market participants. For example, one large producer-handler in the Pacific Northwest market testified that its large grocery customers can balance their supplies with pool sources when the producer-handler plant cannot. (Docket No. AO-368-832; AO-271-837; DA-03-404. Transcript, p. 2374)

The upper limit of the loss to the majority of America's dairy producers who participate in the milk marketing pools is the loss of all Class I value. This would reduce the average pooled price by over a dollar per hundredweight. (Table 1)

Regular home delivery once provided the only example to support the argument that a producer-handler could balance its own supply; it is the only marketing channel that could be consistent enough to make this claim. However, home delivery has declined from 30% of fluid milk sales in 1963 to less than one half of one percent in 1997; and even home delivery sellers can find ways – through seasonal pricing and sales efforts, for example – to shift their balancing burden onto the rest of the market. (*Federal Milk Order Market Statistics for January and February 1999*. USDA/AMS.)

The reality is that no producer-handler plant can truly be made to balance its own supply, because customers always have a choice of alternative sources for fluid milk.

The Need to Eliminate the Producer-Handler Provisions

There is no legal or economic justification for producer-handler provisions, and the Federal order objective of orderly marketing demands their elimination. In its December 14, 2005, final decision for the Arizona and Pacific Northwest Markets, USDA stated that, "Review of the intent of the producer-handler provision and the marketing conditions arising from this provision in these orders could warrant finding that the original producer-handler exemption is no longer valid or should be limited to 150,000 pounds per month Class I route disposition limit. However, the hearing notice for this proceeding constrains such a finding to a level of not less than 3 million pounds per month of Class I route dispositions." (70 FR 74186)

NMPF agrees with USDA's conclusion that producer-handler provisions are an anachronism, and urges USDA to act on this conclusion in this new hearing, whose scope is clearly defined to include the entire elimination of producer-handler provisions.

NMPF proposes to limit producer-handlers to the same size exemption as other processors. In some Federal order markets, large producer-handlers already capture a significant share of Class I sales, undermining the pool value at the expense of producers and pool handlers. Reform of the system is a matter both of equity and of orderly marketing.

Although several Federal order markets are not now substantially disrupted by the operations of large producer-handlers, it is good policy to establish uniform provisions which address this issue proactively, before such a clearly foreseeable problem develops. This proactive approach minimizes the burden of regulation by laying out the rules in advance. The proposed changes would simplify and clarify the responsibilities of current producer-handlers, relaxing the regulatory constraints on their operations, and directing the largest of them to participate in the Federal order pool.

The original reason that the producer-handler provisions were established – i.e., the inability of market administrators to enforce compliance – is certainly no longer valid. The regulation of large producer-handlers would now be no more difficult than that of other handlers, and would restore the principle of marketwide pooling, upon which the Federal orders are based.

Proposal 2: Expanding and Reforming the Exemption for Small Distributing Plants

NMPF also proposes to raise the size limit for exempt plants from 150,000 pounds of monthly Class I sales in an individual market to 450,000 pounds of monthly Class I sales in all markets. This is a distinct proposal, but effecting it concurrently with the elimination of the producer handler provisions can avoid unduly affecting other producer-handlers who have a limited individual impact on the market.

PROPOSAL 1 AND
Proposal 2 ~~standing alone~~ would exempt all but the 10 to 15 largest current producer-handlers, as well as 30 to 35 plants that are now regulated or partially regulated.

(Per Dr. Cryan's testimony)

Today, any plant with less than 150,000 pounds in monthly Class I sales is exempt from Federal order regulation. Given the growth in average farm size, and the growing economies of size in milk processing, it is reasonable to increase the size exemption to 450,000 pounds per month. For perspective, this is equal to the production of about 260 cows, or twice the size of the average dairy herd in the U.S. Plants this small have difficulty competing with large modern plants on cost alone, with or without the pricing advantage offered by producer-handler status.

We urge USDA to consider this increase in the small plant exemption concurrently with NMPF's proposal to eliminate the producer-handler provisions. The principle of raising the limit is sound, and the coincidence of the two proposals will mitigate for most producer-handlers the regulatory impact of eliminating the producer-handler provisions of the orders.

Origin of the Current Exempt Plant Size Limit

Today, any plant with fewer than 150,000 pounds in monthly Class I sales is exempt from Federal order regulation. This limit was made uniform for all orders during Federal order reform. The proposed rule, published in 1998, stated:

"Options 2 and 3 both recognize the Identical Provisions Committee determination that [sic] a handler distributing less than 150,000 pounds per month of fluid milk products does not have a significant competitive effect on the market, and that handlers of such size should, therefore, be exempt from the pricing and pooling provisions of the orders. The level of route disposition required before an exempt plant becomes regulated varies in the current orders.

As recommended, any plant with route disposition during the month of 150,000 pounds or less would be exempt in the consolidated orders. This limit reflects the maximum amount of fluid milk products allowed by an exempt plant in any current Federal milk order and ensures plants that are currently exempt from regulation would remain so. (63 FR 4818)”

This decision confirmed the existing 150,000 pound size-based exemption in the West Texas-New Mexico order (7 CFR 1138.8(e)). This limit was set in 1991, based on proponent testimony. (56 FR 42246) That decision concluded that 150,000 pounds, which was smaller than the size of the average producer in the market, was small enough not to disrupt orderly marketing.

“It is noted that the 150,000-pound monthly size limitation for an exempt plant is substantially less than the average size of producers that are currently associated with these markets. Consequently, it would appear that a plant of such size would not be a disruptive factor in the market either in terms of sales of fluid milk products or in the procurement of raw milk supplies. (56 FR 42246)”

Setting the Size Limit

Based on changed conditions, we propose to raise this limit to 450,000 pounds, consistent with the principles upon which the 1991 decision was made. Between 1991, the year of the West Texas-New Mexico hearing and decision, and 2007, the last year for which data is available, average milk production per U.S. dairy farm tripled from 68,000 pounds to 214,814 pounds. Since the original 150,000 pound limit was based in part on a consideration of farm sizes at that time, this tripling of average per-farm production supports a tripling of the exemption limit to 450,000.

Fluid milk bottling plants generally have increasing economies of scale. That is, the bigger they are, the lower their costs per gallon. This has been consistently demonstrated in industry and academic studies. These economies of scale flatten out, so that the advantages of increasing plant size are greater at the bottom of the range than at the top. Several published studies, including two studies at the University of Maine and a nationwide study conducted by Cornell University, all clearly demonstrate this principle.

Although exempt plants enjoy the same price advantage that producer-handlers now do, for very small plants this advantage is greatly outweighed by high processing costs; so that the price advantage is neither the primary basis for a small handler’s business nor a disruptive force on the market. Given this

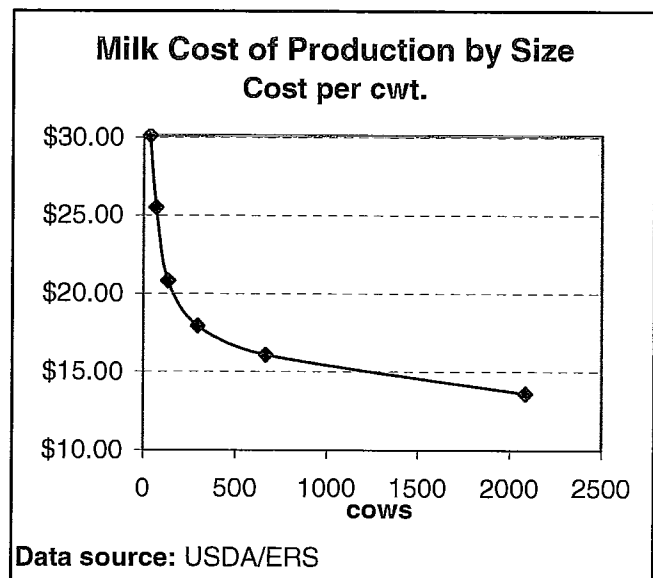
cost structure, such a plant should have little impact on the market, and so its regulation is not necessary to maintain conditions of orderly marketing. That is, such plants will not proliferate on the basis of their regulatory cost advantage.

NMPF recognizes the difficulty of setting any “bright line” size limit. Nevertheless, there remain several good reasons for setting the limit at 450,000 pounds.

It is clear that the current limit is too low. A plant processing the output of a 90-cow dairy cannot compete in the milk commodity market. If the current limit is too low, then raising it incrementally is a positive improvement in the regulation. As a matter of principle, the change should be cautious, increasing to a level that is clearly not too high.

This proposal addresses the regulatory status of milk plants with respect to size, and does not attempt to effect any regulation of dairy farms. However, milk plants obtain their milk from dairy farms, whether they are under the same ownership or not. Farm size has served in the past as a basis for establishing a size limit on exempt plants. In addition, a very large share of the size-exempt plants bottle own-farm production, strongly suggesting that farm bottling is the primary business model for these plants, so that farm size and farm economies of scale must be an important consideration in defining their regulation.

Dairy farms have economies of scale such that there are cost disadvantages to a producer-handler with less than 500,000 pounds of monthly production. This is the conclusion of a USDA study of farm size. In 2005, it was estimated, farms with 500 to 999 cows had a \$4.75 per hundredweight cost advantage over farms with 100 to 199. This is a difference of 41¢ per gallon, and represents a substantial scale economy. In addition, this study showed that 500,000 pounds per month of production (about 300 cows) is near the point where the cost curve begins to get quite steep. That is, below that size, farm cost of



production is clearly high enough that the value of the regulatory exemption will not encourage uneconomic processing paired with production. Based on this data also, 450,000 pounds represents a reasonable bright line limit on regulation of an integrated farm and plant, which is one common business model for small exempt plants. (McDonald, James, et al., *Profits, costs, and the changing structure of dairy farming*. Economic Research Report No. 47; USDA/ERS; Sept. 2007. p. 9)

Under the mandates of the Regulatory Flexibility Act of 1980 and the Small Business Regulatory Enforcement Fairness Act of 1996, Federal agencies must consider impacts of regulation on small business. The formal small business definition for dairy farms is \$750,000 in sales or less. (13 CFR 121.201) As a practical matter, and because revenue fluctuates with milk prices, USDA, the Small Business Administration, and the Office of Management and Budget have determined that regulatory flexibility analysis should be based on a small business definition of 500,000 pounds of monthly milk production. (70 FR 74185) Given that a fluid milk handler can be hard pressed to achieve a Class I use rate of more than 90% of receipts, 450,000 pounds represents an approximate upper limit of the Class I use for a handler within this small business definition.

The small business definition was originally intended to provide a context for consideration of alternative regulatory approaches for smaller businesses, rather than serving as the basis for exemption from meaningful or necessary regulation. Nevertheless, Federal small business definitions are used in a number of programs, such as Federal procurement programs, where a bright line is necessary and where the limit provides one reasonable choice. (Examples may be found at 7 CFR 4280.103, 7 CFR 4290.50, 12 CFR 24.2, and 13 CFR 127.) The small plant exemption in Federal orders was originally intended to alleviate the administrative and regulatory burden of regulating small entities. This intention was consistent with the objectives of the Regulatory Flexibility Act of 1980 and Small Business Regulatory Enforcement Fairness Act of 1996. Those acts recognize that regulation designed with large enterprises in mind can be unfairly burdensome when applied to small businesses, and require consideration of the impacts. Combined with consideration of economies of scale, above, the small business definition for a dairy farm provides a reasonable bright line for the exempt plant definition. The small business definition for dairy plants, by contrast, is 500 employees; such a plant would be very large, and well beyond any reasonable limit for the regulatory exemption under discussion.

Finally, the limit should be set at the same level in all markets, consistent with the decision made at order reform. This should preclude setting the limit in each market according to a proportional impact on the individual market. The market-by-market approach should also be avoided because the larger consideration is whether a proliferation of exempt plants is probable and whether that proliferation could cause disorderly marketing, rather than what the impact of an individual handler may be.

Unique labelling

NMPF further proposes that an exempt plant should not produce any products under brands that are also produced by other plants. Clearly associating an exempt plant's products with a plant-specific brand or brands will enforce the plant's independent nature. This is intended to reduce the potential for the assembly of a supply of packaged milk by a cost-oriented milk "integrator" with substantial control of the exempt plant's product. Without such a limitation, a large retailer could recruit small exempt plants, organizing production in such a way as to remove the diseconomies of scale in marketing and distribution and even, through line specialization, of processing. Such an "integrator" arrangement would violate the intent and spirit of the size-based exemption, which is intended to accommodate small businesses that are unlikely to affect their market, either individually or collectively. This qualification of exemption should be included in any decision arising from this hearing.

Clarifying the exempt definition as based on total plant sales

Finally, NMPF proposes a change in the wording of the size-based exemption, to make clear that the expanded 450,000-pound monthly allowance applies to a plant's total sales, not only to sales in an individual market. This would avoid confusion and would confirm the current interpretation that is applied by the Market Administrators.

This principle should be applied to any decision resulting from this proceeding. That is, any size-based limit on fluid sales should be applied to a plant's total fluid sales, not only sales in a particular market.

Proposal 26: Providing a Conditional Exemption for Existing Producer-Handlers

NMPF submitted an additional proposal that all Federal milk marketing orders be amended to provide a conditional “grandfather” exemption from pooling for current producer-handlers, up to 3 million pounds per month.

This language would allow current producer-handlers to obtain a qualified exempt plant status. Route disposition and sales of packaged fluid milk products by such plants may be no more than 3,000,000 pounds per month, and most of the current conditions for producer-handlers must be met. In addition, the provisions are tightened to prohibit ownership of other farms or other distributing plants by the owner of a plant exempted under this proposal. This may also require conforming language similar to that now used to classify receipts of, and from, producer-handlers.

Regulatory risk is a part of doing business, and we believe that USDA has a clear right to regulate any and all distributing plants, provided that such regulation meets the objectives of the Federal orders. NMPF believes that it is crucial to regulate all producer-handlers distributing more than 3,000,000 pounds of fluid milk products per month and to stem the proliferation of producer-handlers marketing between 450,000 and 3,000,000 pounds per month. NMPF proposes to implement this proposal simultaneously with our previously proposed elimination of the producer-handler provision. These provisions would temper the impact of NMPF’s previous proposal by reducing the regulatory impact on 10 to 15 producer-handlers with between 450,000 and 3,000,000 pounds of packaged fluid milk sales per month, and whose businesses have relied in part upon the current regulations.

Adoption of Proposal 26 remains fully consistent with Proposals 1 and 2. Again, the dual objectives of that petition are to 1) limit the disruptive impact of existing producer-handlers above 3 million pounds and 2) prevent the disruptive impact of a proliferation of new producer-handlers, with sales above 450,000 pounds per month. Allowing existing producer-handlers to maintain an exemption up to 3 million pounds per month will allow these objectives to be achieved without undue regulatory impact on these smaller existing operations.

* * *

Taken together, NMPF proposes to delete Section 10 in Parts 1001, 1005, 1006, 1007, 1030, 1032, 1033, 1124, 1126, and 1131, and all references to those sections and to “producer-handlers”, and to amend Section 8 in Part 1000, as follows:

§ 1000.8 Nonpool plant.

Nonpool plant means any milk receiving, manufacturing, or processing plant other than a pool plant. The following categories of nonpool plants are further defined as follows:

(a) A plant fully regulated under another Federal order means a plant that is fully subject to the pricing and pooling provisions of another Federal order.

~~(b) Producer-handler plant means a plant operated by a producer-handler as defined under any Federal order.~~

~~(c) Partially regulated distributing plant means a nonpool plant that is not a plant fully regulated under another Federal order, a producer-handler plant, or an exempt plant, from which there is route disposition in the marketing area during the month.~~

~~(d) Unregulated supply plant means a supply plant that does not qualify as a pool supply plant and is not a plant fully regulated under another Federal order, a producer-handler plant, or an exempt plant.~~

(ed) An exempt plant means a plant described in this paragraph that is exempt from the pricing and pooling provisions of any order provided that the operator of the plant files reports as prescribed by the market administrator of any marketing area in which the plant distributes packaged fluid milk products to enable determination of the handler's exempt status:

(1) A plant that is operated by a governmental agency that has no route disposition in commercial channels;

(2) A plant that is operated by a duly accredited college or university disposing of fluid milk products only through the operation of its own facilities with no route disposition in commercial channels;

(3) A plant from which the total route disposition is for individuals or institutions for charitable purposes without remuneration; or

(4) A plant that in all markets has route disposition and packaged sales of fluid milk products to other plants of ~~150,000~~ 450,000 pounds or less during the month, all of which are uniquely branded.

(5) A distributing plant that was operated during 2008 by a producer-handler in a Federal order market within the meaning of the Federal milk marketing order at that time, provided that the plant:

(A) Has route disposition in all markets and packaged sales of fluid milk products to other plants in all markets that are uniquely branded and total 3,000,000 pounds or less during the month.

(B) Receives no fluid milk products, and acquires no fluid milk products for route disposition, from sources other than own farm production;

(C) The plant disposes of no other source milk as Class I milk except by increasing the nonfat milk solids content of the fluid milk products received from own farm production; and

(D) Provides proof satisfactory to the market administrator that the care and management of the dairy animals and other resources necessary to produce all Class I milk handled, and the processing and packaging operations, are the plant owner's own enterprise and are operated at the plant owner's own risk, and that the plant owner has no interest in any other distributing plant (except through membership in a Capper-Volstead cooperative association) or in any farms from which the plant does not receive milk. The burden rests upon the handler who is designated as exempt under subsection (5) to establish through records required pursuant to §1000.27 that the requirements of such exemption are met.

* * *

Other Proposals

Most of the proposals in this hearing advocate or assume limits on the exemption of producer-handlers. In this sense, most of the participants here agree that it is appropriate to fully regulate very large producer-handlers, and to make some accommodation for very small plants.

Several of the additional proposals reiterate, in whole or in part, Proposals 1 and 2, as offered by NMPF and IDFA. These include Proposals 10, 16, 19, and 22. We appreciate this support from Way-Har Farms, Coopers' Hilltop Farm, the Pennsylvania Association of Milk Dealers, and the Northeast Dairy Foods Association.

NMPF opposes the rest of the additional proposals, while appreciating that some have been offered in a spirit similar to that of our own proposals.

Proposals 3, 4, 5, 7, 8, 11, 13, 15, 18, 21, 27, and 28 each set a cap for producer-handlers and allow their unlimited proliferation. Each of these is a step in the right direction, but does not go far enough in addressing the potential of a proliferation of medium-sized producer-handlers to disorder milk markets. Although we appreciate the support from these proponents for the principle of limiting the impact of producer-handlers on milk markets, we have made clear above why we believe that producer-handler status should not be extended to any additional plants.

Proposals 6, 9, 12, and 14 would set a new size-based limit for exempt plants at a level higher than 450,000 pounds per month move in the same direction as we propose, but go too far. We believe that a tripling of the current limit to 450,000 pounds is appropriately conservative, as detailed above.

Two of these proposals, Nos. 13 and 14, are offered by the New England Producer-Handlers Association, Inc. et al., a group of producer-handlers naturally seeking to carve out an exemption within the current proceeding, but who we believe would not be substantially affected by the NMPF proposals.

Proposal No. 17 was proposed by Mallorie's Dairy, Inc, Country Morning Farms and Nature's Dairy, a group of middle- to large-sized producer-handlers who are naturally seeking to carve out an exemption for their operations, but who we believe would not be substantially affected by the NMPF proposals. Proposal No. 20 is very similar to Proposal No. 17, so I will discuss them together. These are

nominally a “grandfathering” of producer handlers up to 3 million pounds. However, they go well beyond a simple grandfathering of existing plants with producer-handler status. These proposals would allow any handler that had both fluid milk sales and own-farm production during an historical period to elect to exempt up to 3.41 million pounds of that historical own-farm production, whether or not they had ever qualified as a producer-handler. This is a substantial widening of the producer-handler exemption. These proposals would also drop many of the current balancing requirements of producer-handlers, allowing them to obtain pooled milk from market sources. This is a substantial loosening of the producer-handler qualification requirements.

The effect is to grant a soft, “grandfathered” cap for an expanded group of would-be producer-handlers. Such a cap has been very problematic in California, where political decisions have expanded existing caps and where exempted volumes are used as a pricing weapon by large producer-handlers.

Under this proposal any milk in excess of the defined exemption would be subject to the pricing and pooling provisions of the respective order. Allocating the exempt milk to Class I, as is done in California, would exacerbate this inequity, by reducing and even reversing the pool contribution associated with the pooled balance. Allocating it pro rata to plant utilization still drains a substantial amount of Class I milk from the pool. Even allocating it to the lowest Classes would leave substantially unregulated any producer-handler with up to about 3½ million pounds of monthly volume, in the competition with other, regulated handlers; proposal 23 has a similar effect, but without the 3.3 million pound limit.

Proposals 23, 24, and 25 are proposed by the American Independent Dairy Alliance, a group of seven exceptionally large producer-handlers, who are also naturally seeking to carve out an exempt space for their own operations, and four of whom may be the only handlers whose regulation would be substantially increased under the three NMPF proposals. As we indicated above, and as we believe other testimony will indicate, these large producer-handlers can each have a substantial individual impact on a milk market. They also operate at such a scale that they should not be exempt from pricing and pooling, because, they are large enough to operate on a level playing field with other producers and handlers.

Proposal No. 23 contains two apparently redundant elements. The first purports to allow a distributing plant to elect partially regulated status with respect to its own farm production, but concludes with language that would treat a plant's own-farm milk as part of an individual handler pool, which "shall not be included in the volume of milk or milk components that are subject to payments to or from the producer settlement fund pursuant to Sections _____.71 or _____.72 of any order." I will outline our objections to the individual handler pool shortly.

The second element exempts a plant's own-farm milk from pricing and pooling regulation. This exempt milk is "down-allocated" to the plant's lowest Class uses when calculating the plant's pool obligation for milk from producers. This would mean the plant would pay Class I first for purchased milk. In other words, most distributing plants with a substantial amount of own-farm production would incur a Class I pooling obligation for all the milk that they purchase. The effect of this is that a plant with 95% own-farm production would face a pool obligation equal to a small fraction of what its obligation would be if fully regulated; but a similar plant that elects "exempt" status for own-farm production equal to, say, 40% of its receipts would face a pool obligation substantially larger than its obligation as a regulated pool handler (and so would clearly not elect this status). For a large producer-handler, this amounts to a less restrictive exemption from pricing and pooling ~~than~~ ^{that} the current producer-handler provision.
That
(per Dr. Cryan's testimony)

Proposal No. 24 would exempt milk sold by directly from producer to retail customer, including through home delivery and handler-controlled retail outlets. As I described above, even handlers who sell directly to the consumer cannot be forced to completely balance their own part of the market. Plants that own retail stores can stock other handlers' milk alongside their own, forcing the burden of balancing upon the rest of the market. Even plants that sell only their own milk, through their own retail stores or home delivery, can adjust their pricing and sales efforts seasonally so as to indirectly encourage consumers to rely on other milk outlets when the plant-retailer's supply is short; this also forces the balancing burden onto the rest of the market. The exemption of farm-to-retailer sales in this proposal is inequitable and so should be denied.

Proposal No. 25 would establish “individual handler” pools for all handlers across all orders. This is an especially pernicious proposal. It is a dagger pointed at the heart of Federal orders. Individual handlers pools represent cherry-picking of higher Class I values. Because the plants and cooperatives that effectively balance the fluid milk supply do not receive equalization payments from the pool, they will be unable, in many markets, to maintain the manufacturing capacity that is necessary to balancing. Because the suppliers of fluid milk plants receive a higher price, competition for Class I outlets will destroy producer over-order premiums, further undermining the compensation now paid for market balancing. Market-wide pooling of classified prices is the single most important function of the Federal milk marketing order: with individual handlers pools, the orders would be fatally wounded, and producer losses would be multiples of the losses associated with producer-handlers.

The 1999 final decision on Federal order reform concluded that:

“Marketwide sharing of the classified use value of milk among all producers in a market is one of the most important features of a Federal milk marketing order. It ensures that all producers supplying handlers in a marketing area receive the same uniform price for their milk, regardless of how their milk is used. This method of pooling is widely supported by the dairy industry and has been universally adopted for the 11 consolidated orders.” 64 FR 16130 (April 2, 1999)

It seems beyond question that individual handler pools are inimical to modern Federal orders.

Ultimately, of course, the problem with producer-handlers is that, under the current regulation, they are effectively individual handler pools. The farm side of the business supplies raw milk. The plant, if it is of average efficiency and is operated to maximize the return to the farm, would generate gross returns in line with the regulated Class prices, based on the plant’s use of milk. Like an individual handler pool, the plant can afford to return to the farm a price skewed by high Class I use, without sharing the higher value with the rest of the market.

The rest of the market, which balances the milk supply, loses Class I value from the pool. As a result, other producers and manufacturing plants are less able to balance supplies, leading to disorderly marketing.

Conclusion

The current producer-handler provisions have become outmoded by a changing industry, and we believe that their underlying intent of limiting the regulatory burden of small handlers who do not substantially impact the market is better served through an expansion of the exempt handler provision.

NMPF urges USDA to eliminate the general producer-handler provisions. NMPF also asks USDA to temper these changes with a modest increase in the size-based plant exemption and with a “grandfathering” of smaller existing producer-handlers, in order to avoid imposing an undue regulatory burden on small business that have limited impact on their markets, but whose proliferation could lead to disorderly marketing.

We thank USDA and USDA staff for holding this hearing, as well as for their diligence in providing requested data, and look forward to a positive outcome.

National Milk Producers Federation requests that the following be given official notice:

Erba, Eric, Richard D. Aplin, and Mark W. Stephenson. *An Analysis of Processing and Distribution Productivity and Costs in 35 Fluid Milk Plants*. Research Bulletin 97-03.

Cornell Program on Dairy Markets and Policy. February 1997. Available at:
<http://cpdmp.cornell.edu/CPDMP/Pages/Publications/Pubs/RB9703.pdf>

Dalton, T.J., G.K. Criner, and J. Halloran. *Fluid Milk Processing Costs: Current State and Comparisons*. Journal of Dairy Science Volume 85, No. 4 (April 2002) pp. 984-991. Available at:

<http://jds.fass.org/cgi/reprint/85/4/984.pdf>

Dairy Market Statistics, Annual Summary. Published annually by USDA, AMS.

Federal Milk Marketing Order Statistics, Annual Summary, 1999 & 2002. Published annually by USDA, Agricultural Marketing Service.

Milk Production. Published monthly by USDA National Agricultural Statistics Service.

Early Development of Milk Marketing Plans in the Kansas City, Missouri, Area. Marketing Research Report No. 14. USDA Production and Marketing Administration, Dairy Branch. Washington, D.C. May 1952.

Published Federal order pool calculations for the Southwest Milk Marketing Order for the months of December 2007 through January 2009.

Published lists of handlers with sales in each Federal milk marketing orders, January 2008 through the date of this hearing.

Top 50 U.S. Dairy Cooperatives by Volume, 2007

Rank	Dairy Cooperative	Milk Volume		Estimated avg.
		(Billion lbs)	Members	Cows per farm
1	Dairy Farmers of America, Inc.*	37.1	10,587	173
2	California Dairies, Inc.	17.6	624	1,390
3	Land O' Lakes, Inc.*	12.5	3,015	204
4	Northwest Dairy Association*	7.8	566	680
5	Dairylea Cooperative, Inc.*	5.7	2,250	125
6	Associated Milk Producers, Inc.*	5.5	3,600	75
7	Family Dairies USA	5.1	3,658	69
8	Manitowoc Milk Producers Coop.*	4.7	2,890	80
9	Foremost Farms USA*	4.7	2,400	97
10	Select Milk Producers*	4.4	83	2,594
11	Michigan Milk Producers Association*	3.7	1,515	120
12	United Dairymen of Arizona*	3.0	87	1,718
13	Maryland & Virginia Milk Producers Assn.*	2.9	1,505	96
14	Southeast Milk, Inc.*	2.8	314	446
15	Agri-Mark*	2.5	1,377	90
16	Lone Star Milk Producers*	2.3	249	456
17	Milwaukee Cooperative Milk Producers	2.2	719	150
18	Upstate Niagara Cooperative*	1.5	408	186
19	Continental Dairy Products*	1.5	23	3,199
20	Swiss Valley Farms Company*	1.4	838	84
21	Prairie Farms Dairy*	1.4	789	88
22	Security Milk Producers Association	1.4	33	2,069
23	First District Association*	1.3	832	75
24	St. Albans Cooperative Creamery*	1.2	501	122
25	Woodstock Progressive Milk Producers	1.2	435	134
26	Magic Valley Quality Milk Producers	1.1	35	1,508
27	Zia Milk Producers*	0.7	17	2,058
28	Bongards Creameries	0.7	407	83
29	Lanco-Pennland Quality Milk Producers	0.7	760	44
30	Farmers Cooperative Creamery*	0.7	78	414
31	Ellsworth Cooperative Creamery*	0.6	491	65
32	Plainview Milk Products Cooperative	0.6	280	105
33	Tillamook County Creamery Association*	0.6	120	243
34	Mount Joy Farmers Cooperative	0.5	274	93
35	White Eagle Cooperative Association	0.3	15	1,056
36	Cal-West Dairymen, Inc.	0.3	18	869
37	Burnett Dairy Cooperative	0.3	232	67
38	Lowville Producers Dairy Cooperative	0.3	196	77
39	Cobblestone Milk Cooperative	0.3	14	1,036
40	Scenic Central Milk Producers	0.3	241	57
41	Midwest Dairymen's Co.*	0.2	156	79
42	Humboldt Coop. Creamery Association*	0.2	48	247
43	Central Equity Milk Cooperative	0.2	220	53
44	Cooperative Milk Producers Association*	0.2	102	107
45	Hastings Cooperative Creamery Association	0.2	131	81
46	Sunrise Ag Cooperative	0.2	178	57
47	Calhoun Cooperative Creamery Co.	0.2	85	103
48	Cortland Bulk Milk Producers	0.2	68	123
49	Northwest Independent Milk Producers	0.2	21	390
50	Southeastern Graded Milk Producers Assn.	0.2	179	45
NMPF Total in Top 50		111.3	34,841	158
Top 50 Total		145.5	43,664	164
U.S. Total		185.6	59,130	155

Sources: *Hoard's Dairyman*, USDA/NASS. Asterisks indicate NMPF members.

Other NMPF cooperatives:

Arkansas Dairy Cooperative Association
Just Jersey Cooperative
Scioto County Cooperative Milk Producers' Association

NMPF: Table 1
Selected Annual Price and Pool Statistics for Federal Milk Order Marketing Areas, 2007

FMMA	Base point	FO	Prod Milk (mil. lbs.)	CI I PM (mil. lbs.)	CI I %	CI II %	CI III %	CI IV %	Uniform price	Class I price	Diff. \$/cwt.	Diff. \$/gal.	Pool Loss of All Cl. I	Dist. plants	Pkg'd disp., pool plants	
															Million lbs. per year, all plants	Million lbs. per mo. per plant
Northeast	(Boston)	1	23,040	10,496	46	21	24	9	19.92	21.39	1.47	0.127	-1.23	59	10,521.2	14.9
Appalachian	(Charlotte)	5	5,865	4,120	70	17	5	8	20.36	21.19	0.83	0.072	-1.96	21	4,123.0	16.4
Southeast	(Atlanta)	7	7,521	4,772	63	12	20	5	20.09	21.20	1.11	0.096	-1.93	28	4,799.3	14.3
Florida	(Tampa)	6	3,207	2,604	81	9	5	5	21.29	22.01	0.72	0.062	-3.11	12	2,667.0	18.5
Mideast	(Cleveland)	33	16,268	6,571	40	18	35	7	18.75	20.12	1.37	0.118	-0.93	39	6,451.4	13.8
Upper Midwest	(Chicago)	30	26,490	4,508	17	5	76	2	18.41	19.94	1.53	0.132	-0.31	22	4,412.8	16.7
Central	(Kansas City)	32	11,193	4,345	39	17	32	12	18.67	20.12	1.45	0.125	-0.92	31	4,335.3	11.7
Southwest	(Dallas)	126	9,990	4,161	41	12	35	12	19.35	21.09	1.74	0.150	-1.24	20	4,178.5	17.4
Arizona-Las Vegas	(Phoenix)	131	3,799	1392.5	37	9	28	26	18.95	20.47	1.52	0.131	-0.88	5	1,393.9	23.2
Pacific Northwest	(Seattle)	124	7,036	2,256	32	7	30	31	18.62	20.04	1.42	0.122	-0.67	17	2,219.9	10.9
All Market Average or Total			114,408	45,226	40	13	38	9	19.19	20.81	1.32	0.113	-1.06	254	45,102.3	14.8

Source: Dairy Market Statistics, Annual Summary, 2007

Source: FMMOS, Ann'l Summ., 2007