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Before the United States Department of Agriculture

In the Matter of:	)	
	)	
Milk in the Northeast and Other	)	
Marketing Areas; Reconvening of	)	Docket No. AO-14 -A77 et al
Hearing on Proposed Amendments	)	DA 07-02
to Tentative Marketing Agreements	)	
and Orders	)	

Motion, Pursuant to 7 C.F.R. § 900.7, That the Department Continue This HearingRelating to Proposal 18.

NOW COMES, the Maine Dairy Industry Association, through its attorney, Daniel Smith, Esq. and hereby moves the Department, pursuant to 7 C.F.R. § 900.7, to continue this hearing relating to Proposal 18.

The purpose of this motion for continuance is to allow the Department to expand the record on the MDIA proposal. MDIA proposes the convening of another public information session, along with the use of any other means available to the Department to allow for further input on the MDIA proposal.

Briefing in support of this motion accompanies this motion.

Request of the Presiding Judge, Pursuant to 7 C.F.R. § 900.7, To Certify or submit This Motion To the Secretary For Decision,

Pursuant to 7 C.F.R. § 900.7(b), it is respectfully requested, further, that the Presiding Judge certify or submit this motion to the Secretary for decision.

Respectfully Submitted,

Daniel Smith

Daniel Smith, Esq.
On Behalf of Maine Dairy Industry Association

Before the United States Department of Agriculture

In the Matter of:	)	
	)	
Milk in the Northeast and Other	)	
Marketing Areas; Reconvening of	)	Docket No. AO-14 -A77 et al
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Consideration of Proposals to Amend the Class III and IV Product Pricing Formulas Applicable to all Federal Milk Marketing Orders

Brief in Support of Proposal 18 – To Establish a Competitive Pay Price for Grade A Milk To Be Used as a Factor In Component Pricing

On Behalf of
Maine Dairy Industry Association

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"We farmers, and in our case along with the state of Maine, have for too long been willing to weather the price squeezes and swings by subsidizing the production of milk by mortgaging our future to stay in business.

This national survival of the fittest strategy is wearing nearly everyone down. Absent a better system of returning the value of the product to the producer, in the not too distant future, there will very likely not be enough milk in the system."

"You know, if you as a producer have $5 million in equity and you have used up all of that trying to keep up and pay your bills – because if you don't pay your bills, nobody will service you, you won't have feed to feed your cows. You have to pay your bills. About the only people that you can work with are the banks.

After a while, they kind of tend to lose their sense of humor, and I am sure they have magical figures and numbers that they shoot for; but once you hit a certain point and it doesn't look like you are going back they are going to close you down."

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I. Procedural Posture, Party Standing and Summary of Argument

A. Notice and Substance of the Hearing; MDIA's Participation in the Proceedings

This hearing was noticed on February 9, 2007 for consideration of 18 proposals of amendment to the Class III and IV pricing series.[1] The hearing notice followed the Department's conduct of a Public Information Session in December, 2006.[2] This Session was held to allow for informal questioning and commentary on proposals of amendment to the pricing series, which were previously submitted in response to the Department's June 2006 solicitation of proposals for amendment to product pricing formulas made as part of its "Notice of Intent to Reconvene"[3] the parallel hearing on manufacturing allowances. That hearing had commenced previously on January 24, 2006.[4]

In addition to the hearing conducted in response to the February 9 Notice of Hearing, an additional two hearing sessions were held in this matter.[5]

The Maine Dairy Industry Association, (MDIA) submitted comment in response to the Department's June, 2006 requests for proposal. MDIA participated in the December Information Session in response to the Department's inclusion of MDIA in its notice for the Session. Pursuant to the Department's subsequent, further invitation to Session participants, MDIA submitted a more formal proposal of amendment to the Class III and IV pricing series.

MDIA's submission was included in the Reconvened Hearing Notice of February 9, 2007 as Proposal 18. MDIA appeared and formally participated in the hearing, once reconvened, and in each of the subsequent hearing sessions for the sole purpose of advocating its position with regard to Proposal 18. Walt Whitcomb, dairy farmer and board member, testified in support of MDIA's proposal.[6] Paul Christ submitted expert testimony in further support of the proposal.[7]

Consistent with 7 CFR §900.9(b), MDIA submits this brief in support of its proposal.

[1] 72 FR 6179-6184; February 9, 2007
[2] 71 66749; November 16, 2006
[3] 71 FR 36715; June 28, 2006
[4] 71 FR 545-552; January 5, 2006
[5] 72 FR 13219; March 21, 2007; 72 FR 25986; May 8, 2007
[6] Transcript, April 11, 2007, page 1834 - 1911
[7] Transcript, July 10, 2007, pages 2593 - 2746

B. MDIA's Party Interest and Standing

MDIA is an association of producers representing all 350 operating Maine dairy farmers. The Association is partially funded by voluntary member dues and partially funded by a mandatory, statutory producer assessment. Among its many organizational functions on behalf of its member dairy farmers, MDIA appears in formal representation before the state Milk Control Board and serves as a source of education about the dairy industry for the state legislature. On behalf of its member dairy farmers, MDIA is now moving to establish its formal presence in the federal regulatory arena. MDIA is an "interested" party within the meaning of 7 C.F.R. § 900.9(b).

C. Summary of Argument In Chief; Briefing in Support of Associated Motion for Continuance Made in the Alternative

This brief is in support of Proposal 18, submitted by MDIA, which would incorporate a competitive price valuation factor into the Market Order system's pricing series for Class III and IV Milk under 7 CFR § 1000.50(h) and (j). This partial restoration of competitive valuation is necessary to ensure that the pricing series more accurately reflects the market's true valuation of producer milk used for manufacturing purposes.

In the alternative, this brief is also submitted in favor of MDIA's further, associated **motion, pursuant to 7 C.F.R. § 900.7**, that the Department continue the hearing on this particular proposal. The purpose of this continuation is to allow the Department to expand the record on the MDIA proposal. MDIA proposes the convening of another public information session, along with the use of any other means available to the Department to allow for further input on the MDIA proposal.

This continuation is further proposed to allow for a comprehensive reconsideration of the legal and economic assumptions underlying the Department's prior, complete, replacement of competitive price valuation with component pricing as part of the 1996 Federal Order Reform process, in view of the succeeding regulatory experience with component pricing. It is believed this reevaluation would lead to development of an appropriate and properly constructed factor of competitive pricing that would better align the pricing series with the statutory purpose of 7 U.S.C. § 608c(18).

With adjustment by competitive pricing, regulated minimum prices would more properly reflect the market's long-term valuation of the cost of ensuring an orderly and stable supply of producer milk utilized for manufacturing purposes, in addition to the market's short-term clearing value of this milk, as is currently calculated solely by the pricing series' component pricing formula.

Finally, as a procedural matter, pursuant to 7 C.F.R. § 900.7(b), it is respectfully requested that the Presiding Judge certify or submit this motion to the Secretary for decision.

II. Legal Argument

A. Introduction: State Action and MDIA's Participation in This Hearing

Before moving to MDIA's brief in chief, a background summary of MDIA's somewhat unusual standing to participate in this hearing is instructive.

Largely as a result of MDIA's advocacy on behalf of its state-wide producer membership, over the course of many years, the State of Maine has implemented a comprehensive program aimed at ensuring the long-term sustainability of the Maine dairy industry. In large part, this State action has been in response to the on-going challenge throughout the Northeast region caused by the increasing ineffectiveness of the minimum producer price formula established under current federal milk market regulation to so ensure the long-term sustainability of the region's dairy industry.

As will be described further, in addition to representing the direct interests of its producer members, within the meaning of 7 C.F.R. § 900.9(b), MDIA's participation in this hearing further arises from its experience with this unusual State action.

The Maine Dairy Stabilization Program[8]

Dairying is the largest sector of Maine's diverse agricultural economy. The dairy industry generates $570 million annually to the state's economy. Maine's dairy farmers, processors and agri-businesses combined contribute over $25 million per year in state and local taxes – including almost $10 million in property tax revenues to support local rural

[8] The following discussion is drawn from the testimony of Walt Whitcomb, Transcript, April 11, 2007, beginning at page 1834

communities. The industry provides jobs for almost 4000 Maine people that generate earnings of nearly $150 million each year.[9]

Beginning in November 2001, milk prices sank to unprecedented lows and from that time until May 2003 Maine lost 12% of its dairy farms. In June of 2003, the State responded to this crisis by instituting a series of state disaster relief price support payments totaling over $3 million dollars. The Governor also established a task force to find ways to stabilize the dairy industry and prevent further loss of farms, milk production, and the economic activity associated with the dairy industry.

The Governor's Task Force made seventeen recommendations for stabilizing the dairy industry, ranging from a proposal for the conduct of a formal assessment of its economic value to making state constitutional changes in taxation. Amidst this wide-ranging landscape of how best to fix the problem, there was unanimity of agreement that the core of the problem itself was that the federal system for pricing milk was failing to adequately support dairy farming as an industry in Maine.

Following up on this report, the state again took action and passed an on-going state price support program, known as the Maine Dairy Stabilization Program. This program provides a safety net payment to producers of an amount calculated to be the difference between the blend price paid to dairy farmers under the federal program and the short-run breakeven cost of producing milk in Maine as determined by a state cost of production study conducted by the Maine Milk Commission.

With passage of the Dairy Stabilization Program in 2004, the state took the unprecedented step of providing funds for this program out of the General Fund. By this time, Maine had lost another 10% of its dairy farms and those remaining had been severely weakened financially. In state Fiscal Year 2006, the state of Maine paid $4.7 million in dairy stabilization payments to Maine farmers and is projected to pay $12.5 million by the end of FY 2007 with current monthly payments averaging $1.2 million a month since July 2007.

Maine today has 350 operating dairy farms, all of whom are represented in this proceeding by MDIA. There is ongoing concern among the MDIA membership that this

[9] Data also drawn from "Report: The Impact of the State's Dairy Industry on the Economy of Maine", May 2004

type of state action, direct payment, subsidization cannot be relied upon to mitigate the continuing financial distress in the dairy industry over the long-term.

From its relatively unique market and statewide orientation MDIA has become a participant in these proceedings with the intent of making USDA better aware of the profound, adverse, systemic consequences of current operation of the federal order system and the need for effective change to that system. From its perspective, the state not only cannot continue to subsidize the long-term sustainability of its dairy industry, it should not be so required. Amidst active operation of a federal regulatory program that has long been in place for what was understood historically as intended for the same purpose, it is incongruous that state government has been required to make such substantial expenditures in time and resource to maintain its industry and this vital sector of its rural economy. Most acutely, the federal program of market-derived producer payments should, by all accounts, make such a state program of subsidy payments entirely unnecessary.

The Maine experience is certainly exemplary, but it is not unique. In effect, states throughout the northeast, midwest and the south are confronting the same dilemma. This circumstance, combined with all the testimony of producer distress introduced in this hearing, should establish at the very least that the current, components-pricing design of the pricing series for Class III and IV milk must be subject to a searching scrutiny and reconsideration.

B. The Call for Fundamental Change to Component Pricing and MDIA's Proposal

Consistent with the underlying call for a comprehensive reconsideration of component pricing, it is of course readily apparent that MDIA's proposal is in marked contrast to the other proposals at issue in this hearing. All of the many other proposals provide only for various technical adjustments to the component pricing formula, but are still premised on maintenance of that formula in its essential form. By contrast, MDIA proposes that the Department alter the basic pricing formula by reinstituting a measure of competitive valuation.

MDIA's proposal would thus require the Department fundamentally to reconsider its prior decision to displace competitive valuation entirely with component pricing, and to restore in some measure the historic approach of milk market regulation in place prior to the 1996 Farm Bill Order Reform process.

As noted at the outset, in the alternative to its substantive proposal for amendment to the pricing series, MDIA is hereby moving for a continuance of the hearing on this point. MDIA recognizes that the record may not be sufficient, as it stands today, to prompt in whole part the comprehensive change proposed. MDIA advocates with vigor, however, that the record is more than sufficient to prompt formal, fundamental reconsideration of the decision to exclude entirely the concept of competitive valuation from the pricing series. This brief thereby serves as support for the associated motion for further, formal process as necessary to allow for such reconsideration.

C. Background: Market Order Reform and The Department's Decision-Making Process Under the 1996 Farm Bill

The prior procedure and substantive analysis of the Department's decision to displace competitive valuation and to establish the new component pricing formula provides important background for consideration of MDIA's proposal and associated motion.

It is well understood and accepted that in passing the 1996 Farm Bill, Congress required the Department to engage in fundamental reform of the Federal Order System. As one of many parts of this reform process, the Department chose to undertake a comprehensive review of alternatives to the M-W/BFP competitive valuation formula. At the time of the reform process, the Market Order System relied upon the M-W/BFP competitive valuation formula to calculate the value of producer milk used for manufacturing purposes, and this calculation had long been the historic basis of the system's classified minimum pricing series.

For this part of the Reform process, the Department established an internal AMS/USDA Basic Formula Price Committee "to evaluate and make recommendations for change in the BFP."[10] A University Study Committee (USC), which represented "a geographic cross-section of economic expertise on marketing and pricing of agricultural

[10] R. Knutson, D. Anderson, T. Awokuse, Evaluation of "Final" Four Basic Formula Price Options, Texas A&M Department of Agricultural Economics, Agricultural and Food Policy Center, AFPC Working Paper 97-9, page 4, 1997.

products, including milk", was also established to assist with this review process. In principle part, the USC contained a number of the nation's leading university dairy economists.[11]

Substantive Background – The Department's Working Assumption for the Newly Revised Pricing Series and Section 18 of the Marketing Agreement Act

Both committees issued preliminary reports that expressly delineated their working assumptions, and these are most instructive for defining the substantive basis for the Department's final decision. Most significantly, both stressed the market clearing function of the BFP as the primary consideration. The USC declared at the outset of its analysis:

> USC concludes that in the absence of an effective price support, and, after 1999, no price support at all, minimum Class III pricing takes on special significance in that the market for manufactured products must clear. This requires that the Class III price be set sufficiently low that the market will clear. At the same time, USC recognizes that an important objective of the AMAA is to stabilize and enhance producer returns. It can, however, do so only within the bounds of market relationships and forces affecting the supply and demand for milk in different use classes.[12]

The BFP Committee was equally if not even more explicit.

> The most important criterion is **sound economics** – the ability of the BFP to reflect the supply and demand for raw milk....Sound economics also implies that minimum prices for milk in manufactured products will be market-clearing.[13]

Both Committees went even a step further in emphasizing the primacy of this function of national supply and demand market forces.[14] According to the BFP Committee:

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[11] See R. Knutson et al, An Economic Evaluation of Basic Formula Price (BFP) Alternatives (Interim Report) Texas A&M Department of Agricultural Economics, Agricultural and Food Policy Center, AFPC Working Paper 96-5, 1996

[12] Id at 5.

[13] C. Brenner et al, Basic Formula Price Committee, A Preliminary Report on Alternatives to the Basic Formula Price, Submitted to Director of the Dairy Division, AMS, April 1997, page 7-8.

[14] According to the USC: "USC was not charged with coming up with a recommendation on which alternative performed best in terms of the criteria set forth by the Committee. The reality is that none of the options performed perfectly. There are tradeoffs that exist among the options. Some of the tradeoffs are inherent in the AMAA. For example, the AMAA asserts that order prices should both reflect

> The criterion of sound economics is sufficiently important that it may override other criteria. For instance, supply and demand factors that result in significant price fluctuations may come at the expense of stability; simplicity may conflict with the need to incorporate important supply and demand factors reflecting market conditions for milk. A degree of complexity may be necessary to accommodate sound economics.[15]

Both Committees also identified additional, if subordinate, preliminary review criteria.[16] Inherent in all of these, and leading to its controlling assumption that a "market clearing" function is primarily to be served, is the fundamental understanding that the regulation stratagem chosen will primarily be performing only a short-term supply and demand response function. Particularly based on the then-anticipated elimination of the support program, which otherwise served the function, according to the Committee, in essence the regulatory scheme is intended to allow the market to function as unencumbered as possible, except as necessary for market clearance, in the short-run. If necessary, stability of price over time and even simplicity in the regulatory scheme should be sacrificed to ensure this function.

Against the backdrop of these underlying assumptions, the Committees conducted econometric analysis of the different proposals for change. Based on this analysis, the BFP Replacement Committee chose component pricing, and rejected competitive price

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current economic conditions and be stable. If an alternative is more responsive to supply-demand conditions, it is likely to be more unstable. These tradeoffs are not always explicit in our analyses in that they involve consideration of the degree of reliance to be placed on markets versus regulations."

And, "The most progressive markets are those where there is continuous pressure for adjustment to the highest level of efficiency. Absent government, progressiveness is engendered by competition. If regulation stifles competition, market performance declines.

These relationships underlie the minimum price philosophy espoused at the beginning of this chapter and within the AMAA. Given a choice, it is better that the order price be lower rather than higher. Such a strategy allows the market to operate in a manner that was intended by the framers of the AMAA which, in the view of the USC, reflects substantial vision of the role of government in market regulation." Knutson et al, Economic Evaluation of BFP Alternatives, supra at 31 and 37.

[15] Id at 8.

[16] Id at 5-7. The USC described the need for long life (at least 10 years); understandability ("It cannot be derived from a black box that is difficult to either explain or understand. In other words, the procedure must be transparent in that people can see and understand how the BFP is derived."). Perhaps most significantly the USC declared in no uncertain terms that the proposal would require geographic uniformity, meaning that it must reflect operation, only, of a nation market for manufactured dairy products, with the market alone relied upon to reflect regional differences in product pricing. For its part, the BFP Committee additionally identified stability and predictability; simplicity, uniformity, and transparency; and reduced regulation. Basic Formula Price Committee Prelimiary Report, supra, at 7-8. Geographic uniformity, or adaptation to the national rather than regional markets is a further inference, throughout.

valuation. The Committee rejected competitive price valuation as "questionable in [its] ability to reflect the manufactured milk market"[17] This determination was largely based on its assessment that there was no longer sufficient Grade B milk available as the basis for true competitive valuation.

D. The Commission's Decision Was a Pronounced Departure from Historic Principles of Milk Market Regulation

From the vantage point of the passage of time since the Reform decisions were made, it becomes apparent that the "reformed" Class III and IV pricing series was derived from a pronounced change in understanding of the basic principles of milk market regulation among the key theoreticians involved. Indeed, the BFP Committee's development of its basic premise of the short term, supply demand responsive "market clearing" function of the regulation, and its reliance in whole part on component pricing, followed an equally marked change in analytical thinking about the underlying principles of milk market law, dating back thirty years.

A distinguishing feature of milk market regulation is the continuity of its grounding in a well-established - and equally well-articulated - body of seminal principles, developed over the unusually long period of the controlling statute's active application. Indeed, fully sixty-five years of this history, or since adoption of the AMMA, could be drawn upon during the Market Order Reform process.

These principles are cogently presented and discussed in "The Changing Federal Philosophy on Pricing Milk", co-authored by Dr. Ronald Knutson just prior to his leadership role with the USC.[18] In this 1996 paper, Dr. Knutson first identifies the 1962 Nourse Report for its enunciation of the objectives that serve as the fundamentals for modern federal milk marketing:

- To promote orderly marketing and thereby improve producer income in the long run.
- To equalize the market power of buyers and sellers.

[17] Id at page 6.

[18] R. Knutson and J. Outlaw, The Changing Federal Philosophy on Pricing Milk, Texas A&M, Agricultural and Food Policy Center, Department of Agricultural Economics, AFPC Policy Issue Paper 96-2, page 3, 1996.

- To assure consumer access to adequate and dependable supplies of high quality milk.
- To complement producer organizations in maintaining economic order through coordination of prices and marketing practices geographically and among products.
- To secure equitable treatment of all parties throughout the system.
- To protect established producers against loss of outlets while maintaining freedom of choice among buyers and sellers.

The Nourse report's enunciation of principles is noteworthy for its comprehensiveness of approach to applied regulatory theory, expressly covering all features of the involved market structure. Further, there is a primary focus on the interest of producers, as producers, as well as how their interests relate to those of the other participants in the overall marketplace, including even consumers. This statement of principles is further noteworthy for its express delineation of a long-term frame of reference in time, in the first passage: *"To promote orderly marketing and thereby improve producer income in the long run"*.

According to Dr. Knutson, only a decade later, however, "the 1972 interagency Milk Pricing Advisory Committee boiled down U.S. dairy policy to having three objectives:

- Adequacy of supply.
- Orderliness of markets.
- Stability of prices and production."[19]

In contrast to the Nourse report, the 1972 interagency Report expressly defines only a generally stated concern with market supply, along with equally general statements of concern with regard to stability and orderliness of markets. Other than the indirect reference in the stated concern with "Stability of prices and production" there is no longer any express focus on producer income, and there is no longer a delineation of any regulatory time-frame involved. These concerns, including all of the involved relationships with producer income delineated in the Nourse report, may at best be inferred from the more general statements, if at all.

From the analysis, above, it is now apparent that the BFP Replacement Committee advanced this distillation process to its next logical result, and "boiled" away even "orderliness of markets" and "stability of prices and production" as expressly

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[19] Id.

described objectives of milk marketing. From its perspective, there remains effectively only the single concern for "Adequacy of Supply." Any concern for the producer interest is now at best even further remote from the Nourse report's express delineation. It is also apparent that the Nourse report's concern with long-term supply patterns has also been subordinated if not eliminated.

Again, all that really remains is the single residual "market clearing" concern, as required by the assurance of a current "adequacy of supply". To restate the BFP Replacement Committee's governing goal/criteria:

> The most important criterion is **sound economics** – the ability of the BFP to reflect the supply and demand for raw milk.... Sound economics also implies that minimum prices for milk in manufactured products will be market-clearing....
>
> The criterion of sound economics is sufficiently important that it may override other criteria. For instance, supply and demand factors that result in significant price fluctuations may come at the expense of stability; simplicity may conflict with the need to incorporate important supply and demand factors reflecting market conditions for milk. A degree of complexity may be necessary to accommodate sound economics.[20]

The Committee's adoption of component pricing is seamlessly consistent with this evolutionary change in understanding of governing principles. Consistent with the Committee's ultimate determination about its governing premise for the regulation, component pricing, as a pricing mechanism, reflects only the short-term calculation of the minimum prices necessary to clear the market's demand for the end-product components. In this short-term price calculation for end-product supply and demand, orderliness of markets and stability of price and production have become essentially irrelevant considerations.

In most direct contrast to the essential Nourse report, there is no longer any direct consideration of producer income, nor any consideration of the cost of producing milk. Any such consideration may only drawn indirectly, if at all, from the new "discussion... [in the] technical arena regarding manufacturing costs and yields"[21] required to administer the component pricing formula. In sum, as Mr. Yale testified, the "determinative factor is the cost to make cheese and other dairy products, not how much

[20] Basic Formula Price Committee Preliminary Report, supra at 7-8.
[21] Testimony of Sue Taylor, Transcript July 9, 2007, page 2509-10

it costs to produce milk, or even if producers receive sufficient money to cover their costs."[22]

E. The BFP Committee's Controlling Assumption and Reliance on Component Pricing Emerge as Fundamentally Flawed, as a Matter of Law, From a Plain Reading of the Controlling Statute, 7 U.S.C. § 608c(18)

As should be evident from throughout its participation, it is not the purpose of MDIA in this proceeding to challenge in total the current Class III and IV pricing formula. Nor is the purpose of its proposal to try to devise a product pricing series that will somehow account for the entire cost of producing milk used for manufacturing purposes.

This approach arises in part from an understanding that, without doubt, there is undeniable, logical coherence to the Committee's distillation process, in view of current national market supply patterns in the manufacturing sector of the dairy industry.[23] Perhaps most importantly, the Committee's assessment is further understandable with regard to product pricing in view of the substantial changes in statutory construction that have necessarily occurred over time following adoption of the Price Support Program in 1949 without simultaneous amendment of the parity pricing language of 7 U.S.C. § 608c(18).

As Professor Knutson has concluded, despite its explicit and still-enduring representation in the statute, the primacy of producer parity pricing is better understood as "a stated goal, but hardly an operational goal..."[24] With adoption of the Support Program, it is not unreasonable to understand that producer pricing has been integrated, if not subordinated, into the larger supply and demand dynamic of the manufactured product marketplace as a matter of statutory intent.

Nonetheless, a plain meaning review of the text of Section 18 law and the still-enduring basic public policy purpose of milk market regulation encompassed by the

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[22] Transcript, April 9, 2007, page 1251

[23] While MDIA takes strong issue with the BFP Replacement Committee's determination that the manufactured milk market may only be understood in national terms, this issue is reserved for a later day. For now, it is MDIA's purpose that the Department focus on the Reformed regulation's flawed central premise of serving only a short-term market clearing function without any regard for the impact on producer welfare and the ability of producers to provide for the market's long-term requirements.

[24] Knutson and Outlaw, The Changing Federal Philosophy on Pricing Milk, supra at 2.

statute have not been totally trumped by the manufactured product market's evolution or even the statute's modification, as the BFP Replacement Committee apparently adjudged. Fundamentally, as a matter of law, the assumptions built into the current Class III and IV pricing formula do not sufficiently account for the still-manifest, plain meaning dictates of the statute relating to direct consideration of producer income as the primary consideration in the supply/demand dynamic of the marketplace.

Even granting that producer welfare is no longer the sole or even the primary concern of the statute as it relates to Class III and IV milk, it is simply too much of a stretch to "boil" out any consideration of producer welfare, as has now occurred. On some level, at the very least, the statute expressly requires that the product pricing series account for the impact on producers, as farmers, and not just with regard to the milk they produce.

Perhaps of greatest concern, the current formula's intended function as merely a market clearing device simply cannot be squared, as a matter of law, with the statute's expressly stated concern for maintaining the productive capacity requirements of the market for the long-term. It is here that the needs of farmers, as farmers, and the demands of the market they serve should coalesce as a matter of law and within the meaning of the Nourse Report. These combined and integrated needs and interests must be served under the statute, in a manner that they are no longer served by strict reliance on component pricing.

Section 18 of the Agricultural Marketing and Agreement Act

In total, the operative section, 7 U.S.C. § 608c(18) is as follows:

(18) Milk Prices.

> The Secretary of Agriculture, prior to prescribing any term in any marketing agreement or order, or amendment thereto, relating to milk or its products, if such term is to fix minimum prices to be paid to producers or associations of producers, or prior to modifying the price fixed in any such term, shall ascertain the parity prices of such commodities. The prices which it is declared to be the policy of Congress to establish in Section 602 of this title shall, for the purposes of such agreement, order, or amendment, be adjusted to reflect the price of feeds, the available supplies of feeds, and other economic conditions which affect market supply and demand for milk or its products in the marketing area to which the

> contemplated marketing agreement, order or amendment relates. Whenever the Secretary finds, upon the basis of the evidence adduced at the hearing required by section 608b of this title or this section, as the case may be, that the parity prices of such commodities are not reasonable in view of the price of feeds, the available supplies of feeds, and other economic conditions which affect market supply and demand for milk and its products in the marketing area to which the contemplated agreement, order, or amendment relates, he shall fix such prices as he finds will reflect such factors, insure a sufficient quantity of pure and wholesome milk to meet current needs and further to assure a level of farm income adequate to maintain productive capacity sufficient to meet anticipated future needs, and be in the public interest. Thereafter, as the Secretary finds necessary on account of changed circumstances, he shall, after due notice and opportunity for hearing, make adjustments in such prices.

A plain reading of this statutory language quickly discloses the complete omission from the Committees' working assumptions of any real consideration of a critical, operative section of the statute. Here is the relevant text of this operative section:

> Whenever the Secretary finds...that the parity prices of such commodities are not reasonable in view of the price of feeds, the available supplies of feeds, and other economic conditions which affect market supply and demand for milk and its products in the marketing area to which the contemplated agreement, order, or amendment relates, he shall fix such prices as he finds will reflect such factors, insure a sufficient quantity of pure and wholesome milk to meet current needs *and further to assure a level of farm income adequate to maintain productive capacity sufficient to meet anticipated future needs, and be in the public interest.*[25] (emphasis added)

Again, it is readily apparent and undeniable that the Committees' general focus on supply and demand conditions is well-grounded in this statutory text. It is also readily apparent that the Committee's more specific focus on the "current needs" of the market is also well-placed.

It is equally apparent, however, that neither Committee provided any apparent substantive consideration of the associated clause's basic text that requires addressing the "level of *farm income* adequate to maintain productive capacity *sufficient to meet anticipated future needs.*" The manifest distinction made in the statute between "current" and "future" needs surely merited separate and distinct treatment. Moreover,

[25] 7 U.S.C. § 608c(18)

particularly given the overall statute's still-primary focus on "prices paid to producers" the express dictate for consideration of "the level of farm income" necessary to provide such current and future needs surely should have prompted an extended analysis rather than simply passing mention of the tradeoffs somehow involved.[26]

Distilled to its most applicable language, the statute could not be more explicit with regard to the regulation's intended function: "[T]o assure a level of farm income adequate to maintain productive capacity sufficient to meet anticipated future needs." Viewed against a plain reading of this text, the Reform Committees' operating assumptions about the short-term market clearing function of the regulation and incidental concern for producer welfare, and consequent reliance on component pricing, arguably stands in diametric opposition to the expressly-declared statutory purpose for milk market regulation.

This statutory argument serves as the essential legal premise for MDIA's proposal for the restoration of competitive valuation. As is uniformly recognized, in contrast to component pricing, competitive valuation is grounded in the actual, competitive transaction for the direct sale of milk from producer to handler. By definition, the formula necessarily calculates "producer income" from the sale of producer milk, and thereby assures the proper accommodation of both long and short-term supply for the market, all consistent with Section 608(c)(18)'s express intent.

There may indeed have been increasing infirmity in the ability of competitive valuation to serve its intended function, given the diminution of the volume of available Grade B milk and the increased geographic isolation of the pool of that milk. Nonetheless, the design of competitive valuation was, and remains, conceptually derived directly from the express intent of Section 608(c)(18).

[26] "At the same time, USC recognizes that an important objective of the AMAA is to stabilize and enhance producer returns. It can, however, do so only within the bounds of market relationships and forces affecting the supply and demand for milk in different use classes." Knutson et al, Economic Evaluation of BFP Alternatives, supra at 5.

F. The Factual Record of Operation of the Marketplace Following Federal Order Reform, As Developed In This Hearing, Establishes the Further Need for Fundamental Reconsideration of the Performance of Component Pricing as a Regulatory Instrument, If Not the Immediate Need for Substantial Revision

The voluminous record in this hearing was primarily developed as the basis for the Department's assessment of the propriety of implementing the many various proposals for amending the component pricing formula. As noted at the outset, all of these proposals were premised on perpetuation of component pricing in the main, and so the record, other than as developed by MDIA, is relatively sparse by comparison with regard to the need for fundamental change in the pricing series.

At the same time, the record is vividly obvious with regard to the need for such fundamental change along the lines of MDIA's proposal. In particular, the record describes two concerns that point toward the necessity of ultimate reincorporation of a competitive pay price factor back into the pricing series.

The Hemorrhaging of Farms and Diminution of the Milk Supply in the Northeast, South and Midwest

First and of most immediate concern as a fundamental matter of public policy with regard to the law of milk market regulation, the Northeast dairy industry, along with the Midwest and Southeast, are hemorrhaging producers even while the national milk supply continues to grow. With the hemorrhaging of their productive bases, the milk supplies for the two fluid-based marketing areas of the Northeast and the South have been sharply diminished.

Market Order Statistics, judicially noticed as part of the record, demonstrate this first-stated, most immediate concern. Between 2000 and 2006, the number of farms in the Northeast Order was reduced from 17,279 to 14,284. At the same time, the Order has lost over 1.2 billion pounds of production.[27] As reflected in the recently held emergency hearing for the southeast orders, this circumstance is of even greater, immediate and present concern there.

The dismantling of the milksheds in the southeast and midwest Orders is more than cause for immediate alarm in the northeast. The experience of those Orders is that

[27] Federal Milk Market Order One Statistical Summaries, 2000-2006.

the loss of farm numbers does not obscure for long the loss of basic infrastructure and, inevitably and increasingly irretrievably, the consequent loss of a local milk supply.

This is particularly of concern in a fluid based market such as the northeast. This market is one of the two historic touchstone markets for the federal system. It contains the third and fourth largest dairy producing states, historically, in the country. Amidst such a strong heritage of dairy operation and the most lucrative milk market in the country, milk market order regulation should be expected to operate most effectively to achieve its statutory purpose of "assur[ing] a level of farm income adequate to maintain productive capacity sufficient to meet anticipated future needs, and be in the public interest."

Viewing the combined experience of the southeast, midwest and northeast orders, it is simply not enough to say that the northeast may otherwise rest assured that the "public interest" dictate of the statute is being served by the growing, overall national production that will somehow provide for "adequate supply" for the needs of markets with declining local supply. Such supply is predominantly being developed west of the Rocky Mountains and well beyond what may by any reasonable definition be termed a surplus supply base for the northeast fluid marketing area.

Rather, faced with the region's continued loss of dairy farms and its milk supply, as evidenced in the record by Maine's actions, the states are increasingly called upon to promote instead the public interest in maintaining the long term-viability of the region's dairy industry. As noted at the outset, it is simply incongruous that states should be called upon to make such an investment of public funds when a regulatory, market-based, system is firmly in place and statutorily charged to provide the same function.

In short, as a matter of public policy, operation of the simple clearing price is not serving the public interest as intended b the BFP Replacement Committee theoreticians. When states are called upon to directly subsidize the federally determined minimum producer pay prices, it becomes time to reconsider the Committee's determination of "the degree of reliance to be placed on markets versus regulations". Further exacerbation of the fundamental trends in the expansion of the milk supplies in the west and contraction of milk supply in the east resulting from implementation of component pricing has by now convincingly established that the pronounced, market oriented, approach to milk market regulation has been taken too far, and requires fundamental reconsideration.

The Regulation Failure to Account for Producer Reliance on Equity Investment to Maintain Short-term Market Supplies Is a Fundamental, if Not Fatal, Flaw, For the Long-Term

The second factual basis indicating the need for basic change is apparent across the record of the farmer testimony. This record of the actual on-farm supply response to inadequate pay prices directly rebuts the oft-repeated, theoretical argument that, as long as there is sufficient milk to supply the market, regulated minimum producers pay prices must be understood as being sufficient, even at their lowest.

By marked contrast, every farmer who testified in this hearing, whether big or small and without regard to their regional location in the thriving regions of the west or the depressed Midwest or Northeast made absolutely clear that their ability to maintain production could not be sustained in response to the regulated minimum prices they receive. Without exception, producers testified that they lost money, and in most cases substantial amounts of money, when prices were depressed, and that these losses cannot be sufficiently made up when prices recovered to sustain their operations in the long term. Rather, their ability to continue to supply the market over time depended on their willingness and ability to utilize equity financing to offset their losses in the short-term.

In addition to the first-hand accounts provided by the various producers, the first part of this concern in the record testimony is readily discernible from the statistical summaries of mailbox prices and costs of production for different regions of the country prepared by the Department.[28] In every instance, there is a marked spread between the received price and the cost of production. This spread widens and narrows over time, but is never completely covered over time.

Walt Whitcomb, a board member farmer testifying on behalf of MDIA summarized the farmers' response to this circumstance, to explain how they have been able to sustain their operations, and the likelihood of their ability to continue to do so:

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[28] See e.g. Exhibits 19 and 50.

> The farm community is left with the impression that the Department favors the dramatic price swings as a necessary reflection of the market and that rock bottom prices are the correct level because there continues to be enough milk in the system. Unfortunately the experience on my farm in my state clearly illustrates the real reason there is enough milk in the system. We farmers, and in our case along with the state of Maine, have for too long been willing to weather the price squeezes and swings by subsidizing the production of milk by mortgaging our future to stay in business.
>
> This national survival of the fittest strategy is wearing nearly everyone down. Absent a better system of returning the value of the product to the producer, in the not too distant future, there will very likely not be enough milk in the system.[29]

Mr. Whitcomb further explained his point later in his testimony:

> Looking to the future, the use of equity financing to cover operating expenses is simply not a sustainable strategy. We have made capitol investments in the farm to improve efficiency and to make it attractive to our children, as did both my parents and grandparents before me, and I have understood this equity that we hold in our farm property to represent our retirement as well as investment in our children's future. Under current circumstances, though our daughters are interested in coming back to the farm after school, I worry that this is not a realistic option for any of us.
>
> I do not believe that the farming operation will be sustainable over time in a manner that would allow my daughters to service their debt and enable us to recover our equity. Rather, without change in the pricing situation, I believe we will more likely end like so many of our neighbors, forced to cease operation before we dissipate further our equity interest in the farm property. There is no retirement for dairymen who have indebted all their equity to stay farming.
>
> The issue of my farm's profitability and the current threat to its sustainability is a relatively straightforward computation of the discrepancy between my cost of production and my pay price....[30]
>
> Yet in this past year, with the dramatic decline in federal minimum prices coupled with dramatic increases in feed, energy and utility costs, even these income supplements were not sufficient to cover the $10 dollar spread between mailbox price and cost of production that I discussed earlier. Like so many farmers across the country, I was forced to trim back on or eliminate planned improvements to my barn and other buildings, cut back on equipment maintenance, cut back on non-family labor and reduce my family's draw from the farm. And as I have said, of most concern to

[29] Transcript, April 11, 2007, pages 1838-1839.
[30] Id at 1846-48.

me for the long-term, I have increased my mortgage to provide operating funds.

Looking down the road, this second series of steps that I have taken is not a sustainable approach for the long-term. There are only so many short-cuts, and only for so long, that a well run operation can take before becoming a marginal operation. And it is bad life planning, to say nothing of bad business, to mortgage one's future livelihood for current operating expenses.[31]

As indicated, Mr. Whitcomb's testimony is representative of the farmer testimony throughout the record without regard to size of operation or location. Al Squire, a New Mexico producer, testified of similar problems in New Mexico, where, according to his testimony, the average farm size includes 2000 milking cows:[32]

Q: Now, you mentioned earlier, you said that there was a disaster about to happen and maybe in some case is.
Can you describe any specific situations that you are aware of in terms of particular farms or something that may be started to close down or having some difficulties, that you see happening in your area?
A. Well, I know of several producers Certainly I am not going to name who they are --
Q. I am not asking for names or locations.
A --that have used up their equity so rapidly within the last year, some of them the last year and a half, that they borrowed everything they can borrow. They have borrowed a hundred percent of the value of their cows. Their feed, their land, and there is nothing left....[33]
Q The first response that you mentioned to decreased prices and perhaps price volatility is access to financing to carry you over the low points. And correct me if I am wrong. I understood you to say that a number of farmers have availed themselves of that to the extent that they are able.
If that is the case, what would be the next reaction to a price signal, a reduced price signal going forward?
A. Basically to a price squeeze, is what you are saying?
Q. Yes, to the next price squeeze, assuming it is coming.
A. The next reaction – it is not coming; it is here – is the banks are going to call the notes. You know, if you as a producer have $5 million in equity and you have used up all of that trying to keep up and pay your bills – because if you don't pay your bills, nobody will service you, you won't have feed to feed your cows. You have to pay your bills. About the only people that you can work with are the banks.

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[31] Id at 1852-53.
[32] Transcript, February 28, 2007 at 524
[33] Id at 540.

> After a while, they kind of tend to lose their sense of humor, and I am sure they have magical figures and numbers that they shoot for; but once you hit a certain point and it doesn't look like you are going back they are going to close you down.[34]

As developed earlier in the brief, by both design and construction, the configuration of component pricing does not allow this long-term producer supply response to be reflected in the producer price. Equity financing, by definition, involves investment for the future. Even when, as now, farmers resort to equity financing as a short-term supply response mechanism, equity notes are still long-term financial instruments, calculated for long-term payback.

As earlier developed, such long-term activity was intended to be accounted for by operation of the regulation, under the statute. Yet according to the regulation's current design, and by operation of component pricing, only the effect of the farmer's long-term business activity – the availability of continued supply - is reflected in the price calculation. But the accompanying, long-term increase in the farmer's debt equity is no longer accounted for by operation of the regulation.

According to one strand of theory and testimony implicit throughout all hearings of this type, the regulation's design contemplates market forces in the downstream market, in the form of over-order premiums, somehow to account for this circumstance. According to this theory, the market must provide over-order premiums to make up the difference between producer costs of production and regulated minimum producer pay prices. Otherwise, rational producers will not make the business decisions to employ further investment as necessary to assure continued production.

The short answer to this, once again, largely theoretical argument is resort to the Department's statistics relating mailbox prices to costs of production. Mailbox prices account for over-order premiums. Notwithstanding, persistently, there remains a shortfall between the two.

This is of course an age-old argument in milk market regulation. Yet the BFP Committee's decision to replace competitive valuation with component pricing must be understood as fundamentally changing the age-old, prior dynamic. And, as the record

[34] Id at 578-579.

demonstrates, with increasingly devastating results. In the larger sense, as described, there is now a structural inability of the current pricing formula to account for this long-term supply response by producers - reliance on equity financing. With competitive valuation, in the past, there was at least the potential for the regulation itself to capture the value to the producer of making this equity financing decision, in addition to the opportunity for this value to be captured in an over-order premium. Now, there is only the one chance of its recapture,

As the record demonstrates, this is increasingly a fundamental flaw in the formula's design. Without the capability to value this long-term supply response by producers to chronically low costs of production, as described by both Mr. Whitcomb and Mr. Squire, the regulation is, by definition, positioning the market for a profound day of reckoning.

G. MDIA's Proposal Would Begin the Process of Restoring Proper Competitive Valuation in Substance to the Pricing Series

MDIA's proposal is cogently presented in the record, by its universally well-respected expert witness, Paul Christ, and little would be served by further embellishment.

As apparent from this expert testimony, MDIA does not represent that its proposal, as currently crafted, can solve the myriad of operational problems with component pricing identified in this brief and indeed in the wealth of voluminous testimony developed in the record. MDIA certainly understands that the historic reliance on Grade B milk pricing is no longer a sustainable basis for this alternative formula. Further, without doubt, as apparent from Mr. Christ's direct testimony and the follow-up direct and cross-examination, there remain a number of issues to be resolved with regard to technical operation of the proposal.

Nonetheless, by definition at least, MDIA's proposal could begin the process of realigning the pricing series with its statutory function of directly accounting for the producer's interest and capability to make supply responses. By restoring competitive valuation to the calculation, MDIA's proposal would at least begin to restore the pricing series' capability to again "assure a level of farm income adequate to maintain productive capacity sufficient to meet anticipated future needs, and be in the public interest."

Further, it is apparent from the tenor of the questioning on cross that the proposal is substantive enough to hold tangible promise for actual, functional restoration competitive valuation. None of the questioning reflected opposition in principle to the MDIA proposal, in contrast to so much of the other testimony about the other proposals. Rather, the questioning reflected the oft-stated, common understanding of the hearing, that it would be in everyone's best interest if somehow the pricing series could find its way back to the actual competitive transaction between producer and processor.

Without doubt, the devil is in the details. At the least, however, the proposal has begun to give substance to a means for responding to the critical need, apparent in the factual record of this hearing, and as established by a common reading of Section 18, to reestablish competitive valuation in the pricing series.

Finally, it was correctly noted at the hearing that MDIA's proposal as submitted at the hearing differs in part from the proposal originally noticed, and as such was received as a modification.

III. MDIA's Motion for Continuance Under 7 U.S.C. §900.7.

As stated at the outset, in the alternative, MDIA has filed a motion for continuance, in accordance with 7 *U.S.C.* §900.7. The purpose of this motion is to request that the Department pursue further process as available to develop a more complete record and thereby to allow for a more detailed consideration of MDIA's proposal.

In his testimony, Mr. Christ suggested that a key impediment to the development of this proposal is the lack of available, proprietary data. He further suggested that the Department, having access to this data, is in the best position to develop the concept further. Such further analysis could then be made available to the industry for review and comment.[35]

There obviously is complexity involved in this suggestion, given the procedural posture of this matter. Still, should the Department determine that MDIA's proposal is of sufficient merit to be pursued, it is urged that the Department build on its experimentation

[35] See Transcript, April 11, 2007, pages 2742-44.

with more “informal rulemaking” strategies such as the Public Information Session process previously utilized in this matter.

IV. Conclusion

This hearing has established the need for a comprehensive reconsideration of the statutory intent of Section 18, as well as the need to restore in part the concept of competitive valuation to the Class III and IV pricing series, as reflected in MDIA’s proposal. Comprehensive review of the experience with component pricing as reflected in the record, combined with the historic use of competitive valuation, should lead the Department to begin to proceed toward establishment of a functional, updated version of competitive valuation that will better serve the statutory intent of Section 18.

MDIA readily acknowledges that its proposal may best be understood as a good starting point in this process, as there is challenge in defining a viable, reconfigured competitive pricing formula. It is for this reason, as noted throughout, that MDIA has moved for continuation of the hearing on this subject.

Respectfully submitted,

Daniel Smith

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On behalf of Maine Dairy Industry Association