

Land O'Lakes, Inc.

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Land O'Lakes Dairy Foods

July 1, 1997

Mr. Richard McKee, Director
Dairy Division, AMS-USDA
PO Box 96456
Room 2968, South Building
Washington, DC 20090

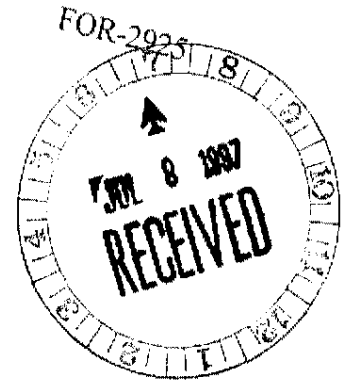
Dear Mr. McKee,

This letter is on behalf of Land O' Lakes, Inc. (LOL), and supplements and amplifies our submission of June 2, 1997. Specifically this letter addresses the issue of Class III-A pricing. Land O' Lakes urges you to reject the recommendation of the Classification Committee that milk used to produce non-fat dry milk be included in a common classification with milk used to produce cheese. LOL supports the continuance of a separate class for non-fat dry milk (NFD) and concurs with the arguments, conclusions and recommendations offered by Agri-Mark in its May 30, 1997 letter to you.

The goal of the institution of the separate federal order class, III-A, was to facilitate the orderly disposition of reserve milk supplies associated with the federal orders. Class III-A pricing has accomplished that goal by providing a price for milk used to produce NFD which more closely reflects the market value of that milk than does the Minnesota-Wisconsin (M-W) or the current Basic Formula Price (BFP).

The BFP is the competitive price paid to Grade B producers in the upper midwest, whose milk is overwhelmingly used to produce cheese. Since April 1995, when the BFP was instituted, the competitive base month price has been updated by a product price formula. This formula, utilizing butter, powder and cheese average monthly prices, is weighted by the volumes of cheese and butter-powder produced in the upper midwest. Typically the weight assigned to butter-powder is less than 5 percent. Thus, the computation of the BFP determines the value of milk used to produce cheese, not butter-powder.

Since 1993 Class III and III-A prices have shown the disparate relationship between the value of milk to NFD and cheese. During the first three full years of Class III-A pricing, the average Class III price was above the average Class III-A price. Those average differences between the Class III and III-A were: 1994, \$1.74; 1995, \$1.10; 1996, \$0.40. During the first five months of 1997 the Class III-A price averaged \$0.26



above the Class III price. The monthly variations over this period ranged from (\$2.69) in April 1994 to \$1.52 per cwt. in July 1996.

These average monthly price relationships point to the fact that the relative values of milk used in NFDm and cheese are fluid and changeable. The short history of III-A pricing reveals that in some periods manufacturers of NFDm require pricing protection, relative to the BFP, and in other periods the manufacture of NFDm enhances the order blend price.

The manufacture of NFDm serves the federal orders through the orderly disposal of the market's reserve production. NFDm serves as the market clearing product and powder plants serve as the market's buffer of seasonal Class I sales and production. Like Agri-Mark's West Springfield plant, LOL's Carlisle (formerly Holly) plant experiences a wide range of monthly volumes. During 1996, plant receipts ranged from 94 million pounds during March to 25 million pounds in September. Clearly, the LOL plant in Carlisle provides seasonal balancing for the market on which it is pooled. In fact, the reporting of receipts of 25 million in September, 1996 overstates the implied volume to manufacturing. During that month over 6 million pounds of milk were loaded out and shipped to deficit southern markets and was assigned Class I on Order 4.

Land O'Lakes agrees with Agri-Mark that the institution of Class III-A pricing was never intended as a vehicle to compensate manufacturers of NFDm for daily or seasonal balancing. Class III-A pricing only attempts to value the cost of milk used to produce powder relative to the value of the end product (NFDm) of that milk. LOL, in its June 2, 1997 Submission, recommends balancing payments be made to all Class III and III-A plants which seasonally balance their markets.

The Classification Committee, while recommending the elimination of Class III-A pricing, suggests that market-wide service payments be substituted to compensate operators of butter-powder plants for balancing the market. The Committee confuses issues related to balancing, with issues related to milk classification. In the above LOL, Carlisle plant example, one would expect that the per unit cost of manufacturing to be the least during March, the month when the plant received the most milk, and to be the highest during September. Market-wide service payments for balancing should compensate the handler when per unit costs of balancing the market are the highest, thus making the handler non-competitive. In the Carlisle example, that month is September.

In reality, the Carlisle plant drew from the pool during March when the Class III price was \$2.38 above the Class III-A price and enhanced the pool in September, when the Class III-A price was \$0.48 above the Class III price. Class III-A pricing is solely a milk classification issue which attempts to value milk based upon the value of its end-products. The BFP clearly values milk used to produce cheese; Class III-A pricing attempts to value milk used to produce NFDm.

The Classification Committee recommends the elimination of Class III-A pricing because increasing volumes of NFDM is being used as a substitute for producer milk in Class II and Class III products. They wish to apply Greshem's Law to the milk industry. That is to say, just as inferior money will chase superior money from circulation, "inferior" NFDM will become the universal substitute for producer milk in Classes II and III, thus undermining Class II and III prices. The Committee believes if Class III-A is eliminated the integrity of classified pricing will be maintained.

This rationale for the elimination of Class III-A ignores the California reality. The federal orders can not outlaw the "inferior" money because it is minted beyond its jurisdiction and is legal tender within the regulated plants. NFDM, produced in California, crosses state lines and competes with all domestically made powder. California, producing over 40 percent of the nation's NFDM and unregulated by the federal orders, will continue to set the national price for non-fat dry milk, irrespective of Class III-A pricing.

Recommendations

Land O'Lakes supports the arguments contained in the Agri-mark Submission, relating to the inadequacy of Central States NFDM Price Series to set a Class III-A price. Agri-mark points out that the Series results from an unaudited telephone poll of manufacturers, located in a region where relatively small amounts of non-fat powder is produced. LOL further agrees with Agri-Marks' conclusion that the Class III-A price calculation use the California NFDM price, as reported weekly. The California Series is audited by the state and is a weighted average of all prices of product sold and delivered during the week.

Land O'Lakes further recommends that the California price be adjusted by a transportation function to determine a midwest price, and that the midwest price be the basis for Class III-A pricing in the new federal orders east of the Rockies.

Land O'Lakes urges the Secretary to continue Class III-A pricing in all of the consolidated federal orders, subject to the modifications contained herein. If you have any questions, please do not hesitate to call me at 612-481-2521.

Sincerely,



Paul G. Christ

Vice President, Dairy Planning & Analysis
Dairy Foods Products Division

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Room 2968, South Building
Washington, DC 20090

Dear Mr. McKee,

This letter is in behalf of Land O' Lakes, Inc. (LOL), and supplements and amplifies our submission of June 2, 1997. Specifically this letter addresses the issue of Class I diversions, as reported in the *Preliminary Report of the Identical Provisions Committee*. On page 19 of that Report, the Identical Provisions Committee noted a request by the Classification Committee prompted the removal of S1007.12 (b) (4) from the template order language.

That provision, currently found in Order 7, would preclude the pooling of a producer, if any of that producer's milk was assigned Class I on another federal order. Such producer would be pooled on the order, in which the milk was classified as Class I.

LOL supports the concept of Class I diversions and recommends that the Identical Provisions Committee file a final report which allows handlers the flexibility to deliver milk from pooled producers to other order distributing plants without losing the pool status for such producers. Since producers, delivered to distributing plants in other orders would be eligible to be pooled on that order, the handler would have the flexibility to choose the order on which the producer is to be pooled.

The reason for LOL's support for Class I diversion is a logistic one. Often, when supplying distribution plants with direct shipped milk, handlers inadvertently include the milk of producers pooled on other markets. Distribution plants may or may not be located in the milk shed of the order on which the plant is pooled. Additionally, such plants may be found at the edge or border of an order's marketing area and within the common milk shed of another order. In such instances it is economically prohibitive and often logistically impossible to segregate producer milk by the order in which it is pooled.

Another instance of inadvertently delivering other order milk to distributing plant occurs when milk is being reloaded for shipment to distant Class I markets. The act of combining milk picked up on separate trucks at a reload facility sometimes includes milk not intended for out-of-market shipments.

Currently, the orders allow other order milk at a distributing plant up to the level of Class II and III receipts at the plant. Volumes which exceed those levels are forcibly pooled on the order which the plant is pooled. Notwithstanding the efforts of the Identical Provisions Committee, it is expected that the consolidated 10 to 14 federal orders will somewhat be different from each other in method of producer payment (component pricing) and pooling provisions. Allowing handlers to choose the pool status of other order milk delivered to distributing plants, will result in a less complicated payment to producers.

Land O'Lakes' support for this provision is contingent on two items. First, that the Department adopt LOL's proposal that location value outside of an order's marketing area be the same as the Class I price as defined by the Cornell Dairy Model (Land O'Lakes' Submission to AMS, June 2, 1997, S100X.52). That is to say that the location value of an other order distributing plant should be equal to the other order's Class I price at location and should not be determined by a transportation formula based on distance from the market. Handlers would account to the pool at the Class I price at plant and producers would be paid blend price at location.

Land O'Lakes has proposed the use of the results of the United States Dairy Simulator (Cornell Model) as a basis for a national Class I pricing surface. The model generates a national Class I pricing surface based on the relative marginal value of Class I milk at specific geographic locations. It is only logical to use this pricing surface to determine an inter-order Class I and producer pricing surface. Moreover, the Department has previously used Class I differentials in the several orders to determine inter-order location value, S1005.53 (a) (6), and, in the *Partial Final Decision for Orders 5, 7, 11 and 46*, the Secretary has recommended Class I differentials in the several orders to determine the net transportation credit.

Additionally, the classification of the milk passed from the order of plant receipt to the producer's order should be determined just as transfers between pool plants are now determined (S.100X.42). Receipts of transferred milk are allocated to Class I based on the lower of the receiving plant's Class I utilization or the market-wide Class I utilization.

Producers, pooled on the receiving order, should be indifferent to whether the other-order producer is pooled on the receiving order or whether the milk is a Class I diversion from the sending order. The last hundredweight of milk, pooled on the order, will receive a blend price determined by average market-wide utilizations. Class I diversions, like transfers, will draw from the receiving order Class I volumes, determined by the lesser of the receiving plant's or the receiving order's Class I utilization.

One would expect that in the majority of cases, the handler will choose to pool the producer on the order which enjoys the higher utilization and higher blend price. In the case of sending supplemental milk to deficit Southern markets, it would be expected that Class I diversions would only be used for short-term logistical reasons.

In the case of a distributing plant located in the milk shed of two or more orders, it would be expected that handlers would use Class I diversions on a more permanent basis. Again, the order of the receiving plant would pass to the sending order Class I volumes determined by the lesser of the plant's or order's utilization which is no more than the producer would draw, if that producer was pooled on the order of receiving plant.

However, if the utilization and the blend price of the sending order was above the receiving order, it could be expected that handlers will choose to pool producers on the higher utilization market and use Class I diversions to supply distributing plants in neighboring orders. Over time such a strategy will tend to bring the blend prices of the two orders closer together, because the sending market will have Class I pounds passed back to it at a lower utilization than already exists in the receiving market.

By adopting the concept of Class I diversions the Department will help facilitate movements of milk between orders. We appreciate the opportunity to comment on this issue and any questions on this submission, please call me at 612-481-2521

Sincerely,

A handwritten signature in cursive script, appearing to read "Paul G. Christ". The signature is written in black ink and is positioned above the printed name.

Paul G. Christ
Vice President, Dairy Planning & Analysis
Dairy Foods Products Division