Before the Secretary
United States Department of Agriculture

Regarding: Milk in the Appalachian and Southeast Marketing Areas; Proposed Amendments to Orders

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Post-Hearing Brief

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Introduction

The National Milk Producers Federation (NMPF) is the voice of America's dairy farmers, representing over three-quarters of America's 70,000 commercial dairy farmers through their membership in NMPF's 34 member cooperative associations.

We testified in Atanta and are submitting a post-hearing brief in support of those parts any proposal that would limit the producer-handler exemption to 3 million pounds in any order or orders arising from this proceeding. The producer-handler issue is one of national scope, so that the outcome of this hearing, in addition to being important on its own basis, will set an important precedent for all other orders. NMPF supports such a limit in every market, in order to address both current and potential future market disruption arising from the distortions of the producer-handler exemption.

The current producer-handler exemption began as a matter of expediency, not principle, and after 70 years conditions demand its modification. Changes in technology and the growth of the largest dairy farms offer a new model of producer-handler. Large producers can now capture sufficient economies of scale in processing their own-farm milk in order to exploit the artificial raw milk price advantage offered to exempted producer-handlers - an advantage of as much as 16¢ per gallon. A single such producer-handler can, by itself, disrupt the orderly marketing of milk in a market. More importantly, such large producer-handlers could proliferate across a market, causing even greater disruption in aggregate, despite the arguably limited impact of one on a large market. This could thoroughly undermine the pooling of market values.

Original Basis for the Current Producer-Handler Exemption

The Federal milk marketing order program 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 the modern milk marketing orders.

Although many markets were supplied primarily by handlers who procured milk from producers and cooperative associations, in the Kansas City market producer-handlers sold 50% of the milk and cream consumed when the market's license was instituted in 1935. This license was to regulate them. However, the market administrator encountered considerable resistance from a substantial number of these producer-handlers, who generally failed to submit reports and who refused to make payments to the equalization fund when they did submit reports. Most of the rest followed suit when the market administrator failed to enforce these requirements on non-compliers. Successive amendments to the marketing agreement were made to lessen the burden on producer-handlers, but since no effective enforcement accompanied even these, non-compliance among producer-handlers continued to grow. In July 1935, unable or unwilling to surmount the practical difficulties of enforcement, the department abandoned its attempts to regulate producer-handlers beyond reporting requirements. *That is, producer-handlers were exempted from regulation as a matter of administrative expediency.* This is the status that producer-handlers of all sizes enjoy today in all Federal order markets.

In May 1935 the Supreme Court invalidated the National Industrial Recovery Act for its excessive delegation of Congressional authority to the executive branch. The marketing agreement and licensing provisions of the Agricultural Adjustment Act of 1933 gave the President and Secretary of Agriculture similarly broad and ambiguous powers over agriculture. In August of 1935, for this reason, Congress amended this Act to codify the previous practices of the USDA, re-establishing the licensing of handlers as Federal milk marketing orders. 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. This language has been retained to the present day, as part of a continuous system of milk market regulation; for example, the recent creation of the Central Federal Milk Marketing Order incorporated the Greater Kansas City Order, which had been continuously in force since its December 1936 establishment as a successor to the license discussed above.

Sources:

Federal Milk Market Order Statistics Annual Summaries for 1999 & 2002. USDA/AMS.
Early Developments of Milk Marketing Plans in the Kansas City, Missouri, Area. 1952; USDA.

A Changing Industry

The early difficulties in regulating producer-handlers gave way over the years to indifference about their regulation, due to their shrinking numbers and small size. Even today, in many markets, most potential producer-handlers fall under the 150,000 pound size exemption, so that only in the Arizona-Las Vegas marketing area does a large share of the fluid milk market belong to handlers exempted as producer-handlers. 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.

In 2003, however, there were 440 dairy farms with over 2000 cows, compared to only 235 just five years earlier, when they were first counted. A 2000-cow dairy produces roughly 3 million pounds per month. The average farm in this category produced 5.8 million pounds per month in 2003 (compared to 4.7 million in 1998). These 440 farms now produce 18% of the U.S. milk supply. They are more than large enough to exploit both the producer-handler raw milk price advantage and economies of scale in fluid milk processing. Their share of production means they could capture a large share of the Class I sales in an individual market or nationally, if many of them adopted this model.

Sources:
Milk Production. USDA/NASS, February 2004.
Dairy Market Statistics, 2002 Annual Summary. USDA/AMS, 2003.

The Cost Advantage of Producer-Handlers and resulting uneconomic reorganization.

Our statement at hearing on February 25, 2004, and Exhibit 59, as well as Exhibit 57 from Mr. Herbein, demonstrate the following. Producer-handlers have a price advantage by avoiding Federal order regulation. They have a cost disadvantage that outweighs this when they are small, so that the exemption cannot be the primary basis for their business, and they are not disruptive to the milk market generally. However, as they grow larger, the price advantage is great enough to allow a producer-handler to make it the primary basis for the firm's operation, and to undercut the market.

The analysis presented by NMPF in Exhibit 59 provides the foundation for establishing a limit for the size of exempted producer handlers. (The legal basis for this is well-argued in the briefs of other proponents.)

Producer Equity.

The exemption violates the principles of producer equity upon which the Federal orders rest. In the best case (vertical integration of efficient milk production with efficient milk processing) the exemption robs the producer pool to pay producer-handlers. In the worst case (uneconomic reorganization of farms into producer-handlers) the exemption also creates deadweight losses in the market whose whole cost is borne by pooled producers.

Orderly Marketing.

Such an exemption also threatens orderly marketing. Based on numbers in recent years, by 2004 farms with over 3 million pounds of monthly production should produce about 20% of the U.S. milk supply, equal to about 50% of U.S. fluid milk sales. These numbers are steadily increasing. The ability of such farms to exploit such an exemption threatens both the producers and the handlers currently supplying U.S. markets.

Further, such producer-handlers, even if they bottle all of their milk and buy or sell no more, can now sell to wholesalers or retailers at an advantageous price. Such wholesalers or retailers can either balance their own supplies of milk, 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.

Regular home delivery once provided an argument that a producer-handler could balance its own supply; it is the only marketing channel that is 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. (*Federal Milk Order Market Statistics for January and February 1999*. USDA/AMS.)

The conclusion must be that no producer-handler plant can truly be made to balance its own supply.

The Need for a Limit

There is no justification for the producer-handler exemption generally; but the Federal order objective of orderly marketing demands an end to the exemption for large plants. However, a recognized difficulty in limiting the producer-handler exemption (as opposed to the simplicity of eliminating it) is determining the appropriate level for that limit. The analysis discussed above offers one approach, and its results suggest a limit in the neighborhood of 3 million pounds.

Three million pounds is also the limit recently set by Congress as the limit for exemption from payment of the Fluid Milk Promotion assessment (7 USC 6402). There are some similarities between the Federal milk marketing orders and the order under which the fluid promotion program operates. Both make certain individual fluid milk marketing responsibilities into common ones. The Fluid Milk Promotion threshold of 3 million pounds is implicitly a level above which the individual handler's responsibility to the market as a whole is great enough to require a contribution to the common mission. Also, the Supreme Court has explicitly identified promotion programs as necessarily an integral part of large schemes of regulation; and in that sense, these orders are part of the same program, administered by the same agency.

In a dynamic dairy market, any attempt to fix a limit too finely may be self-defeating. Technologies change, market prices and rates of Class I utilization change, and there is a risk of setting a limit that is too high, leading to uneconomic investment that may be lost when the limit is re-adjusted.

NMPF believes that the limit should be set at the same level in all markets, concludes that 3 million pounds is the appropriate level, and supports the proposals to set the limit at that level in any market or markets emerging from this proceeding.

Clarification of Issues Raised at Hearing

We wish to address a number of points of economic theory raised at hearing. Economic interpretation is crucial element of the legal reasoning that must be applied to such economic regulation as Federal orders. As such, clarification of economic points are appropriately addressed in this brief.

Transfer Pricing

Deciding on the price theoretically paid by a producer-handler plant to its farm is a matter of transfer pricing. Transfer pricing is frequently applied in tax law to determining the taxes to be paid by a firm transferring intermediate goods (such as raw

milk) between parts of the same firm that are in different tax jurisdictions. The standard basis for setting the transfer price is the market price. There is a complication in the context of Federal orders; that is that a pooled plant pays one price and the producer receives another.

In order to reduce analysis to that of the plant, it is appropriate to define the transfer price as the market uniform price, plus any prevailing market premium. This assumes that the farm side of the producer-handler operation is as efficient, and compensated that same as, any other farm in the market. Unlike pooled plants, the producer-handler plant pays the same price to the farm that the farm receives, so the price paid by the producer-handler plant is also the price received by the farm. That is, the producer-handler plant pays the uniform price. This is a proper basis for comparison of producer-handler plants to pooled plants.

Legally, the producer-handler does have two distinct parts of its business, if only because the Federal order language clearly defines a "producer" and a "handler". These two parts of an otherwise "seamless" business are, in practice, defined separately as soon as the producer-handler fails to meet the conditions of its special status; so there should be no difficulty recognizing the possibility of establishing the principle of payment from one half to the other.

Here is another way to consider the transfer price. The market uniform price plus prevailing premiums is the opportunity cost of the farm. That is, it is how much the producer-handler's farm part is giving up to supply the milk to the plant part.

Alternatively, analysis could compare the costs face by a plant and producer participating in the Federal order pool, to an identical plant and producer who are exempt from the pool as a producer handler. The clear difference is the difference between the uniform and Class I prices, which the pooled plant-producer combination must pay into the pool and which the producer-handler does not.

This can produce a deadweight loss to the market, as described below:

A producer-handler sells milk at a market wholesale price, p_r, and faces costs at the plant (c_p) and the farm (c_f).

$$p_r - (c_p + c_f) = \text{margin for producer-handler}$$

An identical plant and producer sells at the same price and faces the same costs, plus a pool payment equal to the Class I price (p_{ClI}) minus the uniform price (p_u):

$$p_r - (c_p + c_f) - (p_{ClI} - p_u) = \text{margin for pooled producer and handler}$$

Clearly, the difference, the advantage, is the pool payment made by the pooled handler that the producer-handler does not make. This means that a producer-handler can be less efficient, by as much as $p_{ClI} - p_u$, and remain in business, as a result of this exemption.

Each of the three approaches offered above produces the same results on the same principle. This principle defines the basis for measuring the advantage offered to producer-handlers by their exemption.

Relation of FMMO's to Fluid Milk Promotion Order

We testified that the Federal milk marketing orders are vitally related to the research and promotion orders. In addition to other shared elements outlined in testimony, we here point out that the Fluid Milk Promotion Order defines applicable fluid milk products according to whatever definition is adopted by the Federal milk marketing orders. (7 CFR part 1160.107) This is the same regulation whose application is limited to handlers of more than 3 million pounds of "fluid milk products" per month. (7 CFR part 1160.108)

Regarding Risk

The issue of "risk" faced by producer-handlers has been raised at hearing. An argument has been made that they face greater risk because they must balance their own supply and manage their own outlets. To the extent that any such risks are borne by producer-handlers, they are a function of the conditions for their regulation. Once regulated, these risks - and their associated costs - would cease to exist for these plants.

Relating Theory to Applied Analysis Regarding Processing Efficiencies of Scale

The analysis presented in Exhibit 59 presented empirical results regarding the cost efficiencies of larger plants and related those efficiencies to the raw milk price advantage enjoyed by producer-handlers. These show decreasing processing costs as plants are larger, and that the per-unit costs tend to flatten out at very large plant sizes. All the cited studies are broadly consistent in this. They are also consistent with the common understanding that certain inputs to production, typically defined as overhead, have substantial costs regardless of the size of the operation. These costs are less per unit, when spread over a larger volume of production, are reduced and lead to just the kind of unit cost to size relationship demonstrated in each study.

Conclusion:

It has been clearly demonstrated in hearing and in briefs filed on behalf Dairy Farmers of America and Dean Foods that there is a legal basis, even a requirement, that producer-handlers that are large enough to affect their market, even in aggregate, be regulated.

Proponents have identified 3,000,000 pounds per month as consistent with the exemption limit in the related Fluid Milk Promotion Order and so a natural limit for the producer-handler exemption.

Analysis has been presented in hearing by Cryan and Herbein demonstrating the consistency of 3,000,000 pounds per month with the approximate size at which a plant may base its profitability upon the price advantage accruing to an exempt producer-handler.

No attempt to force a producer-handler to balance its own supply can be entirely successful, since at the limit, consumers can change their source of milk, based price, forcing the rest of the market to balance the supply.

For all of these reasons, and the reasons cited in testimony, the National Milk Producers Federation supports that part of any proposal which limits the producer-handler exemption to handlers with less than three million pounds in monthly sales.

Respectfully submitted,

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