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January 22. 2001

Hearing Clerk
Room 1081 South Building
United States Department of Agriculture
Washington, D.C. 20250

Re: Proposed Findings, Conclusions, and Brief,
Milk in the Pacific Northwest Marketing Area.
Docket No. AO-368-A29. et. al., DA-01 -06

Mr. Secretary, Ladies and Gentlemen:

The above-identified administrative rule making proceeding primarily involves the pooling of milk on the Pacific Northwest Federal milk Marketing Order (Order 124). The evidence for the proceeding was submitted at a hearing on December 4, 2001.

Northwest Dairy Association is a cooperative association, which markets the milk of more than 600 dairy producers whose milk is pooled in the Pacific Northwest Order. Northwest Dairy Association is a member of Northwest Milk Marketing Federation (NMMF). We also represent over 100 dairy producers who are pooled on the Western Order market. Our subsidiary operating company, WestFarm Foods, operates plants throughout Oregon, Washington, and Idaho.

Northwest Dairy Association is a co-proponent of the proposals heard at the hearing, along with NMMF. We have reviewed the Proposed Findings, Conclusions, and Brief of NMMF, and we endorse it as our own. These proposals are designed to prevent what we call "artificial" pooling of out of area milk - by which we mean, the pooling of milk on Order 124 that is not attached to that market by the traditional measures of attachment, but which is "artificially" pooled on the order for the sole purpose of drawing money out of the Order 124 pool.

We at NDA are very concerned about that practice, and we are asking USDA to adopt what we think are reasonable changes which will stop the practice. We sincerely believe that this practice makes a mockery of the Milk Marketing Order system, and that it plays into the hands of those who want to end the Federal Order system. It is necessary to stop this abusive practice if Federal Orders are to retain the support of the industry and political support within Washington, D.C.

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<u>Background Information Regarding the Problem.</u> All orders permit some portion of the pooled milk to be diverted to nonpool plants, either inside or outside the order. It is fair to say that prior to the 1996-99 -Reform" process, every order also had <u>other</u> provisions which measured attachment to the market, so that milk that does not truly serve the market would not share in the Order's returns through the pooling mechanism:

- Many orders have had "touch base" provisions, by which milk must be delivered to a pool plant or other plant with a specified frequency. Such deliveries demonstrate attachment with the market.
- Many orders, including the Pacific Northwest, have a "dairy farmers for other markets" provision, which requires that if a dairy farmer serves multiple markets, such a dairy farmer can not be a -producer" under the order unless all of his or her milk is pooled during the month. We believe the intent was that those who are not always part of this market could not use "surplus" milk to raid the Order 124 market while still primarily serving another market.

  Some orders, including the Pacific Northwest, formerly had provisions, which applied an economic factor to ensure attachment. Producers who claimed to be serving the market were free to do so, but if they delivered their milk to a plant outside the order (closer to home), the producer would receive less for that milk. That was because value of the milk to the market was reduced, if it was located away from the market. This was a basic application of the principle of location pricing - if milk is outside the marketing area, it is worth less than it would be if it is next to the plants in the marketing area, until money is spent to haul it to the plants in the marketing area. Since milk delivered to plants outside the area has not been transported, it has lots of miles to go (and transportation cost to be borne) before it attains the same value to the order's plants as milk which has been delivered to the market. For that reason, the prior order provision established a location value that diminished mile by mile, the further pooled milk was delivered from marketing area.

To illustrate how that prior order provision worked, if NDA had attempted to pool on the old Order 124 milk from our producers in SW Idaho, while delivering that milk day in and day out to our plant in Caldwell, Idaho, we would have drawn the Pacific Northwest order's blend price less a location adjustment of $.555 less per cwt on milk received at Caldwell. That location adjustment provision effectively would have kept us from doing such artificial pooling of Idaho milk, had we wanted to, even though there were periods when it would have been to NDA's financial advantage to have pooled Idaho milk on Order 124.

All that changed, of course, on January 1, 2000. The problem was not that USDA elected to establish a national Class I pricing surface. The problem was that when

USDA elected to utilize that surface as the sole location adjustment factor for all other classes of milk, the market attachment provision just described was removed from the order and not replaced with another measure of market attachment.

We do not believe that impact on manufacturing milk was intended. Indeed, as we review the Final Decision [Docket DA-97-12; April 2, 1999] we note that all of the comments regarding location pricing focused on milk for fluid use; for example the second paragraph of the 27 page discussion of the "Class I Pricing Structure" introduces the subject by noting:

> *"The reform effort provides the opportunity to consider and establish a nationally coordinated Class 1 pricing surface that uses location adjustments to the [Class I] differential levels to price milk for fluid use in every county of the United States.*

From that starting point, however, we find that milk for manufacturing assumes location values that mirror the Class I values ... with the curious result that milk pooled on a given market can be valued based on supply demand conditions halfway across the country (or further). How did this happen? To try to determine this, we have searched the 1999 Final Decision (there was no Recommended Decision under the expedited procedures established by Congress).

After searching the Final Decision page by page, and using the marvels of modern software to conduct appropriate word searches, we have concluded that there was no discussion of why the Class I pricing surface was applied to adjust blend price payouts on milk delivered to manufacturing plants distant from the order area. We suggest that this may simply have been an oversight, which could easily have occurred given the complexity of rewriting orders in a process that deprived the industry of the opportunity to directly comment on the complete order framework.

Still, the decision to use the Class I price surface to establish location values of manufacturing milk was not surprising -previously it had been done that same way. The only change in the order was that the national pricing surface for Class I milk had bumped aside the old practice of using location adjustments to provide an incentive to move milk from manufacturing plants "in the country" to bottling plants in the populated areas. To some extent the location surface still does this; for example, milk delivered to our Sunnyside, WA plant (in "the country") draws less from the pool than milk we deliver to a Seattle bottler. But by ignoring the impact on out of area milk, a "backwards incentive" was introduced into Federal orders to move milk to a manufacturing plant further away from the order's bottling plants in distant order areas:

- Cornell University had a computer model which allocated milk supplies to plants and allocated products from those plants to market centers, and then

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"solved" for the lowest "system transportation cost". The model produced a "price surface" map, which demonstrated that milk for both manufacturing and bottling was worth more in the east than in the west.

- USDA then used that model to establish a Class I price surface, but ignored the variable price surface that the Cornell model indicated for manufactured products. Nevertheless, USDA applied the Class I surface to govern location adjustments to pool draws from manufacturing plants.

- Under the Pacific Northwest order, milk delivered to one of the cheese plants near Salt Lake City ($1.90 per cwt) has the same location value as milk delivered to a pool plant in Seattle. That is because the base location value in the Pacific Northwest is the $1.90 at Seattle. This turned upside down traditional theories of location value. I would also point out, in passing, that if milk pooled on Order 124 is delivered to other areas in the country with higher location values (for example $2.90), such milk would be adjusted upward in value in what it draws from the Order 124 pool (in the example, by $2.90 minus $1.90, or $ 1.00), even if it is sent to a <u>manufacturing</u> plant in the distant area.

- Note that milk delivered to a cheese plant in Utah had a greater location value than milk delivered to our cheese plant at Sunnyside ($1.75/cwt) for purposes of adjusting blend price payments, even though that same Central Washington milk often moves to the $1.90 pool plants at Seattle and Portland. So there <u>is</u> an incentive to move milk from Central Washington to Seattle and Portland bottlers, but <u>no</u> incentive to move milk from Utah to the same bottlers.

- Because the blend price in the Pacific Northwest is often higher than the Western Order blend price at Salt Lake City, the order system provides an incentive for milk produced in Utah to be delivered to cheese plants there, <u>rather than</u> being delivered to a Utah bottling plant. That is because if that milk goes to a Salt Lake City bottler, it would be pooled in the Western Order and draw the lower blend price. In classic Federal Order analysis, this would suggest the potential for disorderly marketing conditions.

- So, one Irony is that if a Utah cheese plant's milk is pooled on Order 124, the system discourages that milk from moving to Salt Lake City bottlers, and provides absolutely no incentive to move milk to Pacific Northwest bottlers.

- Another Irony is that the greater value is provided by the order system at the expense of producers in the Pacific Northwest, who are still expected to serve the Pacific Northwest bottlers.

- But the crowning Irony is that the Order system based on the Cornell model encourages Utah milk to be pooled to the west, while the economics in the Cornell model show that milk should move to the east!

The foregoing explains what has happened over the past year in this region. Dairy Farmers of America pooled producers located in Utah, whose milk we understand was delivered to a cheese plant in Utah. When that milk is artificially pooled in the Pacific Northwest order, the Utah milk draws a higher blend price than if pooled in the Western Order. Paradoxically, then, the pool draw from Order 124 on the milk delivered to the Utah cheese plant has been higher than the pool draw from Order 135 on other milk delivered to Class I facilities in Utah. This has created disorderly marketing conditions in two markets. The Western order has neighboring producers with milk receiving different pool values (as discussed above), while in the Pacific Northwest order the proceeds of the pool loading were also in part used to "plus" the market, to obtain more in-market milk on which even more pool loading could be based (four pounds of pool loading. for every pound of new milk within the order area and delivered to pool plants).

I do not know how I could explain all of this to a Member of Congress. We strongly suspect that USDA does not want to have this difficulty of explanation, either ... other than to say that it was a mistake that is now being fixed.

To summarize the foregoing:

- Before "Reform", the location value where pooled milk was delivered would diminish, in proportion to distance, the further away the receiving plant was from the bottling plants in the marketing area.
- During "Reform", a new theory of Class I location value was established, – perhaps unintentionally - provides an incentive to move milk to a manufacturing plant which happened to be located in an area that would have had a higher Class I value, rather than to a bottling plant in a region that has a lower Class I value. That happens because milk delivered to a manufacturing plant has a greater or lesser value, <u>depending on the pool to which it is attached.</u> As illustrated above, this situation creates an opportunity for artificial pooling to be used to pay more to producers delivering milk to manufacturing plants – more than to other producers who deliver milk to bottling plants. I submit that this has created the potential for disorderly marketing conditions.

Of course that contradicts traditional Federal order theory. We are focused today on one small aspect of that contradiction. And that is, that the new location pricing system supplanted the prior measure of attachment to the Pacific Northwest market.

We note that other orders had different measures of attachment (such as "touch base" and delivery provisions), which were retained during the "Reform" proceedings. But no such measures were added to orders (like the Pacific Northwest) which had relied upon location pricing to measure attachment, rather than touch base. This change opened up the door to “pool loading".

That current "pool loading'" practice simply has no place in the system of geographically separate orders which were established in the 1999 Final Decision based upon eight "commonality criteria" such as natural boundaries like mountains, etc. [Page 4 of Section II entitled "Discussion of Material Issues and Amendments to the Orders", Docket DA-97-12; April 2, 1999].

- One of the factors relied upon by USDA at the time in the Final Decision was common utilization [Page 4 of Section II entitled "Discussion of Material Issues and Amendments to the Orders"]. It would make no sense for USDA to establish an order boundary between the Pacific Northwest and Western Orders. in part *because* of different utilization (more Class IV in the Pacific Northwest and more Class III in the Western") if the intent is to allow Western Order milk to be paper pooled on the Pacific Northwest Order whenever Class IV is higher than Class III.
- One of the other factors that led USDA to retain the Pacific Northwest Order area virtually intact during the "Reform Consolidation" process, was that *"There is almost no relationship between the Pacific Northwest Area and Southwestern Idaho-Eastern Oregon marketing areas, and no basis for a consolidation "* [quoting the Final Decision at page 138]. Little has changed since 1999. There is now some milk moving in condensed form from the WestFarm Foods plant at Jerome, Idaho, to fill unused plant capacity in the WestFarm Foods plants in Washington. Because it is condensed (to reduce transportation costs), the milk can not be used by bottlers. Furthermore, that situation is temporary, and is expected to end within a year when the current expansion of the Jerome facility is completed. To the best of our knowledge, none of the "pool loaded" milk from farms in Southern Idaho or Utah is actually delivered to a plant within the Pacific Northwest marketing area.
- As I have just suggested, one of the factors used to divide up the different marketing areas was "overlapping areas of milk supply". This had been a traditional consideration in Federal order theory for decades, but it is interesting to note that the rationale for doing so, as expressed in the Final Decision, was that *"The competitive factors affecting the cost of a handler' s milk supply are influenced by the location of the supply. The pooling of milk produced within the same procurement area under the same order facilitates the uniform pricing of producer milk."* We note that when a handler in a distant, lower paying order uses artificial pooling to draw better returns from the Pacific Northwest (or any other higher paying order), the intended uniform pricing in the distant order is frustrated. It is even more frustrating to that goal of the Federal order system because it is an opportunity that is difficult to take advantage of, except

by large, multi-order cooperatives. Such an unintended favoritism of large cooperatives is politically risky, and must be addressed if political support for Federal orders is to be maintained.

Indeed, many critics of Federal orders see the present "pool loading" phenomenon as confirming that, in their eyes, the system is something of a joke. If so, it is a joke that USDA must correct if we are to maintain support for Federal milk marketing orders. We are aware of other hearings affecting other orders on this same issue. We urge the Department to develop a national approach to ending this "pool loading" practice.

For the reasons just identified, Northwest Dairy Association urges the Secretary to adopt of the NMMF proposals 1 and 2, including any changes that NMMF is urging. They seem to be unopposed, and non-controversial. They will help restore the integrity of the Federal Order System.

Emergency Conditions. The present diversion provisions have caused, and continue to cause, NDA and our producer members significant and irreparable economic loss that demands prompt amendatory action. Until such action is implemented, the Market Administrator's January 4, 2001 temporary decrease in diversion limits to 80 percent in all months should continue in effect.

Under 7 CFR Section 900.12(d) a recommended decision may be omitted. All of the record evidence in this proceeding supports the adoption of Proposals No. 1 and No. 2. and all testimony by participants supported omission of a recommended decision.

Accordingly, NDA joins NMMF in requesting that a final decision and order be issued at the earliest possible time, amending the provisions of the Pacific Northwest Milk Marketing Order in conformity with Proposals No. 1 and No. 2.

Respectfully submitted,

Douglas C. Marshall,
Sr. Vice President

cc: James R. Daugherty, Market Administrator
Bill Van Dam, CEO, NMMF
NDA Board of Directors