

**Prepared Testimony of
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Re: Proposal No. 4, "Cooperative Pool Plant Changes"

Federal Milk Market Order Hearing
Docket Nos. AO-368-A30; AO-380-A18; DA-01-08
April 16, 2002

My name is Daniel S. McBride. I am testifying today on behalf of Northwest Dairy Association, which is usually referred to as "NDA". In earlier testimony I have introduced myself, as well as NDA and WestFarm Foods.

NDA Opposes Proposal No. 4. As we understand this proposal, Section 7(d) of the Western Order (Order 135) would be amended to change the performance standard for cooperative pool plants, to require that 50% of the milk associated with the cooperative is delivered or diverted to pool plants.

Today, our cooperative has no plant designated as a "cooperative pool plant", but it is entirely possible that someday we may if market conditions warrant and the language of Section 7(d) is suitable.

The practical effect of this Proposal No. 4 would be to increase the portion of a cooperative's milk that it would have to deliver to pool distributing plants if it chose to designate a "cooperative pool plant" under Section 7(d) of the order. In order to meet these increased percentages, the cooperative that operates such a plant would have to do one of two things:

1. It could reduce the amount of milk it puts through its reserve plant, and deliver more of its existing milk to distributing plants. This would be expensive, because of the high fixed costs associated with a manufacturing plant, and because of the tremendous "opportunity cost" of not running the plant near its capacity.
2. Alternatively, the cooperative could increase the total amount of milk it has, in order to both keep its plant full and still deliver 50% of its total milk to distributing plants. This seems to be impossible to achieve, because we are not aware of any distributing plants that need more milk than they are presently receiving, or who might be willing to get part of their supply from a second source.

Note that one variation of that second point would be for a cooperative like ours, which owns a distributing plant, to attempt to expand the route distribution of such a plant. However, that can be done only by taking sales away from existing plants. Based on our experience with the Boise plant, I can testify that it is difficult to increase sales except by price cutting.

Given that reality, then, it can be seen that Proposal No. 4 could readily create disorderly marketing conditions. I offer the following hypothetical situation to illustrate this point:

- Plant A, which is investor owned and has only one goal -- to make money. Plant C, which is cooperatively owned, certainly has the same goal, but it also has an incentive to increase its sales in order to ensure that its owners are pooled – two goals.
- Being owned by the cooperative, Plant C can make its producer owners happy by cutting wholesale prices and taking sales away from Plant A. Indeed, it may be rational for such a plant to operate at a loss, in order to increase its sales. Put a different way, Plant C has an incentive, created by the Order, to return to its owner-suppliers a price lower than the Class I price.
- When Plant C attempts to do so, Plant A must meet or beat Plant C's lowball prices, or lose the business. If Plant A lowers its price, it probably can not recoup its Class I cost of raw milk, unless it can sell its "pooling rights".
- The result of both plants' activity would be that the concept of uniform class pricing would be threatened, and disorderly markets would clearly have been created. Plant C and its cooperative owner would be doing precisely what is done in the classic textbook illustration of "disorderly marketing conditions", which is to accept a lower price in order to obtain access to the preferred Class I market.

In this hypothetical situation, both Plant A and Plant C would come out losers, and so would all other plants who would be impacted by the "cutthroat competition" that would pervade the wholesale market for sales of Class I and II products. But we submit that the real loser would be the reputation of the Federal Milk Marketing Order system. There are at least two reasons why this would be so. The foremost is that government action should not encourage uneconomic actions, and the Plant A's of the world would have every right to object and to ask Congress to fix the problem. I would argue that Congress has already fixed this problem, by establishing as statutory goals of the Federal order system the creation of uniform pricing to handlers and the prevention of disorderly marketing conditions.

A second reaction would develop – and I think it already has developed – regarding the sale of pooling rights. As explained earlier in my testimony regarding Proposal No. 3, USDA should be taking steps to correct that practice.

Virtually all of my prepared testimony regarding Proposal No. 3 also applies to Proposal No. 4. There is no need to repeat it, but I will summarize the points that are relevant here:

1. The Department's traditional approach has been to evaluate the supply and demand conditions of a market, and to establish delivery percentages for reserve supply plants – including cooperative pool plants – at levels which ensure that milk moves to pool distributing plants when needed, and moves efficiently to reserve plants when not needed by the Class I market.
2. We are aware of no situation in the Western order market in which that reserve milk has not been made available to pool distributing plants. We at NDA are prepared to supply such needs, if requested to do so.
3. However, even assuming that someday there were to be unmet needs, the order language already provides a solution, by which such a plant may request that the Market Administrator adjust the delivery requirements.
4. We see no purpose behind these two proposals other than to make the sale of pooling rights more lucrative.

In connection with this Proposal No. 4, it is appropriate to develop further the concept discussed in connection with Proposal No. 3, that if the goal is to make more milk available to the pool distributing plants, these provisions should be made more workable so that they can actually be utilized.

Specifically, we suggest that this proposal be modified to reduce the current 35% percentage delivery requirement to 10%, rather than increase it to 50%. Then a cooperative such as ours, with roughly one-quarter of the milk being pooled in the market, could utilize this provision. As it stands, NDA would have to deliver 35% of our milk to distributing plants to utilize this provision. If we are 25% of the market in a given month, then we'd have to deliver 35% of our 25%, which would be 8.75% of the entire market's milk. But the combined Class I & II utilization of the Western order market is only 25% of the market's milk. In order to utilize this provision today, NDA would therefore need to deliver roughly one-third of the needs of the pool distributing plants.

NDA supplies one-third of the Class I and II market in the Pacific Northwest marketing area, and we would be very comfortable with a one-third share of the Western order's Class I and II market. But the fact is that to achieve that level, and to

be able to use the cooperative pool plant provision with even the present 35% requirement would necessarily require us to displace others who presently supply those Class I and II plants. There are two very real problems with that:

1. First, the major pool distributing plants in this Western order market are today all tied up with long term single source supply contracts, with DFA. I will discuss that in more detail, in a minute
2. Second, even if that were not the case, the only way we could achieve a 25% market share would be to cut price. Doing so would almost certainly create disorderly market conditions.

Given that even the present 35% provision is unrealistic for us to meet in the Western order, we would support reducing that percentage. We suggest 10% be the new percentage, for two reasons. First, it is the number used in the supply plant provision in the Upper Midwest order, which is similar in class utilization to the Western order. More importantly, it matches the 90% diversion limitation in the Western order, which should be retained as we will demonstrate further in our discussion of Proposal No. 6.

General Concerns That Class I Market is Foreclosed. As earlier noted, NDA is in the business of selling milk to pool distributing plants. We are ever-alert to the potential to do so in the Western order market, in particular at Salt Lake City where none of the plants is competing directly with the WestFarm Foods plant at Boise. There are three major distributing plants there:

- The Smith Food and Drug Centers plant in Layton, Utah is owned by the Kroger Co., with whom we have a supply relationship at Portland, Oregon. We understand, and I believe this record already shows, that they currently have a long term, full supply contract with Dairy Farmers of America.
- The Cream O'Weber plant at Salt Lake City is owned by National Dairy Holdings, Inc., which is in turn partially owned by Dairy Farmers of America. DFA is also the supplier of that plant.
- The Meadowgold Dairies plant in Salt Lake City is owned by Dean Foods. As has already been testified, they have a supply relationship with Dairy Farmers of America. We do not know the precise nature of that arrangement, but in the March 29, 2002 edition of Cheese Market News, it is reported that "*DFA also has a milk supply contract with the new Dean Foods.*" The CEO of Dairy Farmers of America is quoted as saying, of the recent transactions that spun off their interest in what became Dean and created National Dairy Holdings: "*The transactions gave DFA members the best of two worlds. We remain the milk supplier of choice to the new Dean Food Co. and gain an equity interest in National Dairy Holdings that gives us even wider market opportunities and a tremendous growth vehicle*".

NDA submits that as long as Dairy Farmers of America has effectively foreclosed access to the major pool distributing plants in the Western Federal Order Marketing Area, USDA can not fairly grant the DFA proposals at this hearing which would require other cooperatives and non-member producers to increase their service to pool distributing plants.

In addition, it should be recognized by the Department that the impact of these proposals to restrict the pooling requirements will not increase the supply of milk available to these distributing plants unless the effect of the proposals is to make it easier for DFA to take producers away from others in the market. The Department has a legitimate interest in ensuring that the distributing plants receive adequate supplies of milk. But there will not be convincing evidence at this hearing that those plants can not receive adequate supplies today, under current order provisions. I emphatically testify, and assure the Department, that Northwest Dairy Association is willing and able to supply additional milk to them, if needed.

To bring this discussion back to Proposal No. 4, as long as the potential for cooperatives like NDA to make additional deliveries to the pool distributing plants at Salt Lake City is foreclosed by long term, single source supply contracts, the Federal order philosophy behind the cooperative pool plant provision would indicate a need to reduce, rather than increase, the percentage delivery requirement.

Proposal 4, which combined with the net effect of the proposals 3, 5, 6 & 7, seem designed to greatly reduce the amount of milk pooled in the Western Order. It is proper to examine who is the beneficiary of this group of proposals. It is of course the one organization which controls the vast majority of the Class I sales, and which has submitted these proposals. Very few producers would have access to the pool except through DFA.

In effect DFA seems to be asking USDA to grant them greater control over access to the Western Order. Doing so would also give them the opportunity to leverage the provisions of the order into the potential sale of pooling rights. That would make a farce of this Federal order, and it would play into the hands of those who would like Congress to end the order system. We ask USDA not to take such actions, in these or any other proceedings.

I would be happy to answer any questions.

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