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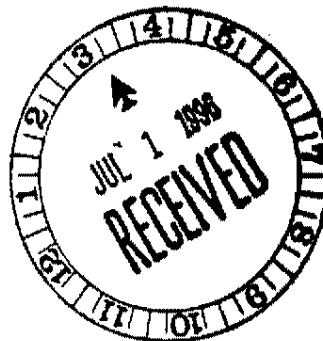


Land O'Lakes Dairy Foods

June 26, 1996

FOR-9

Mr. Richard McKee, Director
Dairy Division, USDA, AMS
Room 2968, South Building
PO Box 96456
Washington, DC 20090-6456



Dear Mr. McKee:

Enclosed is a set of proposals for Federal Milk Order reform. The core recommendations are:

1. Get rid of location adjustments;
2. Provide open pooling so that any plant can pool on any market; and
3. Use transportation credits and balancing payments to make producers and plants that ship to the fluid market better off than those who do not.

The package of proposed reforms submitted herewith will make Federal Orders more effective, more fair, and more efficient.

Sincerely,

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

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Land O'Lakes, Inc.
Proposals for Federal Milk Order Changes

1. Make sure that distributing plants are able to get milk for fluid use whenever and wherever they need it.

How to do it:

- a. Make those who supply fluid plants better off than those who do not.

- 1) For direct shipped milk:

- Provide transportation credits out of the pool to cover 80 percent of the hauling cost
- Pay transportation credits only on milk delivered to fluid plants.
- Transportation credits provide flexibility for milk to move in any direction from any source to a fluid plant.
- Total transportation credits should be limited to 120% of Class I use at the receiving plant

- 2) For supply plants:

- Provide transportation credits out of the pool to cover 80 percent of the hauling cost from the supply plant to a fluid plant.
- Provide balancing payments out of the pool that compensate for 125 percent of the opportunity cost of releasing milk. (An example of a balancing payment calculation is presented in the Appendix)

- b. Get rid of barriers to the pooling and movement of milk.

- Get rid of shipping requirements for supply plants. This would allow a supply plant to be regulated and pooled on the market of its choice and would make an abundance of milk available to every market.
- Get rid of location adjustments. Location adjustments, combined with supply plant requirements, are effective economic barriers that create deficit markets, rather than relieve them. Transportation credits are more effective incentives to move milk than location adjustments. Also, with no location adjustments, price alignment problems disappear.
- Allow transfers between markets to be allocated to Class I in the same manner as transfers within markets.

- c. Require commitment to the market. A supply plant operator could choose once a year where his milk is pooled. Once a market is chosen, he would be required to perform under any and all calls issued under that order for the succeeding 12 months, or be subject to severe penalties.

 - d. Adopt a "call" provision in each order.
 - Fluid processors and suppliers would make supply arrangements as best they can.
 - A "call" for milk would be issued by the Market Administrator whenever he finds that supply commitments are not adequate to satisfy fluid requirements.
 - The "call" would be issued to individual supply plants in a manner that would minimize the combined cost of transportation credits and balancing payments. In effect, this would mean that nearby milk would be called first.
2. Provide sufficient price incentives to get Grade A milk produced, released from supply plants, and shipped to fluid processors.

How to do it:

- a. Adopt a two-tiered Class I price differential.
 - The first tier would compensate Grade A producers, through the pool, for the extra cost of producing Grade A milk. A differential of \$1.00 in all markets would be adequate for this purpose. There would be little concern about where the Grade A milk is produced if the barriers to pooling and shipping milk are eliminated.
 - The second tier would vary in each market and would be set annually by the market administrator to fund the cost of transportation credits and balancing payments.

- b. Adopt transportation credits and balancing payments as suggested above.

3. Provide uniform prices to producers and handlers.

How to do it:

a. For producers

- Get rid of location adjustments
- Allow open pooling of supply plants in every market

b. For handlers

- Adopt a uniform base Class I differential (\$1.00) in all markets
- Adopt a uniform supplemental Class I differential (to cover transportation credits and balancing payments) within each market.

4. Replace the basic formula price.

How to do it:

a. For Class I: Calculate the average price at which milk for the futures contract months of the current quarter is being traded during the preceding quarter on the Coffee, Cocoa and Sugar Exchange.

- Represents a competitively determined price
- Directly represents the price of milk for the current quarter
- Provides decoupling from Class III pricing
- Provides for quarterly pricing
- Requires that futures contracts be established for all 12 months of the year
- Provides the opportunity for fluid processors to "lock in" their costs of milk in advance.

b. For Class III: Calculate the average price at which milk for the current futures contract month is being traded during the first of the month through the second-last day of trading on the Coffee, Cocoa and Sugar Exchange.

- Represents a competitively determined price.
- Mimics the value of milk in the "cash" market due to convergence.
- Provides an opportunity for milk manufacturers to "lock in" their cost of milk in advance.

5. Simplify the orders.

How to do it:

a. Get rid of the shrinkage, route returns and animal feed provisions of the order.

- Anything that is not accounted for in Class II, Class III, or Class III-A is Class I.
- There would no longer be a need to audit Class I disposition.
- Would eliminate much complex language in the orders.

b. Regulate fluid processing plants in the market where they are located.

- Would eliminate volatility due to plants switching markets.
- There would be only minimal price alignment problems because of more uniform Class I prices and elimination of location adjustments.
- No need to track where fluid milk is distributed.

c. Eliminate location adjustments.

6. Provide advance pricing for Class I butterfat.

How to do it:

a. Calculate the average price at which Grade AA butter for the futures contract months of the current quarter is being traded during the preceding quarter on the Chicago Mercantile Exchange.

b. Add to the Class I basic formula price 965 multiplied by the difference between .138 times the above butter price and .0098 times the Class I basic formula price.

7. Consolidate the existing 33 orders into no less than 10 nor more than 14 orders.

a. Northeast

- New England
- New York
- Middle Atlantic

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b. Appalachian

- Tennessee Valley
- Carolina

c. Southeast

- Southeast

d. Florida

- Upper Florida
- Southeastern Florida
- Tampa Bay

e. Rustbelt

- Southern Michigan
- Ohio Valley
- Eastern Ohio - Western Pennsylvania

f. Northern

- Chicago Regional
- Michigan Upper Peninsula
- Upper Midwest
- Iowa
- Central Illinois
- Southern Illinois - Eastern Missouri

g. Ohio Basin

- Louisville - Lexington - Evansville
- Indiana
- Paducah

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h. Missouri Valley

- Eastern South Dakota
- Nebraska - Western Iowa
- Kansas City

i. Cattle Country

- Southwest Plains
- Texas
- New Mexico - West Texas

j. High Plains

- Black Hills
- Eastern Colorado

k. Mountain

- Great Basin
- Central Arizona
- Western Colorado

l. Northwest

- Pacific Northwest
- Southwest Idaho - Eastern Oregon

m. California

Appendix: Balancing Payments

How to do it:

1. Determine the month during which the greatest percentage of milk in the pool is used for manufacturing. (Class III and Class III-A) e.g. May.
2. Calculate a seasonal index of the milk in the pool.
3. For each supply plant, calculate a "normal" manufacturing use for each month based on (a) the volume of pool milk associated with the plant in May, and (b) the seasonal index of pool milk production.
4. Pay balancing payments on the lesser of:
 - a) the volume of shipments to fluid processing plants and,
 - b) the negative difference between the actual manufacturing use during the month and the "normal" manufacturing use for that milk.
5. The amount of balancing payment would be the estimated fixed costs of a cheese plant of efficient size (2,000,000 pounds per day capacity) divided by the annual production capacity times 1.25.
 - Fixed cheese plant costs amount to about \$.80 per cwt. of plant capacity.