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MARKET ADMIN. F.O.#30
MPC

March 1, 2017

Victor J. Halverson
Market Administrator
Upper Midwest Milk Marketing Order No. 30
1600 West 82nd Street, Suite 200
Minneapolis, MN 55431

Re: Request to Reduce Shipping Requirements and Diversion Limits

Dear Mr. Halverson,

This letter is in response to your request for comment on the request pursuant to §1030.7(g) to reduce the shipping requirements in the Upper Midwest Order found in §1030.7(c) and §1030.7(f) as well as the proposed increase in the diversion limits found in §1013(d)(2) and §1030.13(d)(3). Dean Foods owns and operates five pool distributing plants regulated by the Upper Midwest Milk Marketing Order. Dean Foods strongly opposes the request submitted by the Upper Midwest Marketing Agency (UMMA) and the Central Milk Producers Cooperative (CMPC) to reduce the shipping percentage from 10% to 7.5%, and the complementary increase in the diversion limit. While Dean understands that the Market Administrator has the discretion to adjust the supply plant shipping percentage, we feel it would be better served in this case to hold a formal rulemaking hearing to address larger regulatory issues directly related to the request. While the reduction may seem like a small request on the surface, should the Market Administrator choose to oblige the Cooperatives it would represent a 25% decrease in the shipping percentage. By increasing the potential size of the pool, this proposal would lead to lower blend prices (and thus disorderly marketing conditions) as Class I milk becomes an even smaller portion of the milk in the Order 30 pool. In fact, should more milk be pooled in the higher differential zones as a result of this request it could lead to an increase in the depooling of milk in the lower differential zones.

The Federal Order system is predicated around regulation of Class I fluid milk plants and, through various regulations, has given “special status” to fluid bottlers in return for charging the higher Class I price for the milk. As the result of the ‘higher of’ provision, Class I prices, in nearly every month, are the highest in the pool. Class I plants are the only plants that are not allowed to elect not to pool milk and are the only class of milk that are not allowed to forward contract on their milk. In return for these regulations the Federal Order system is set up to ensure that an adequate supply of milk is made available in order to meet the demands of fluid bottling plants. In return for supplying milk to Class I plants, supply plants are eligible to share in the Order’s Class I revenues. Supply plant shipping percentages ensure that distributing plants have access to an adequate supply of milk and allows for a reserve supply of milk to be available to serve the needs of the Class I market.

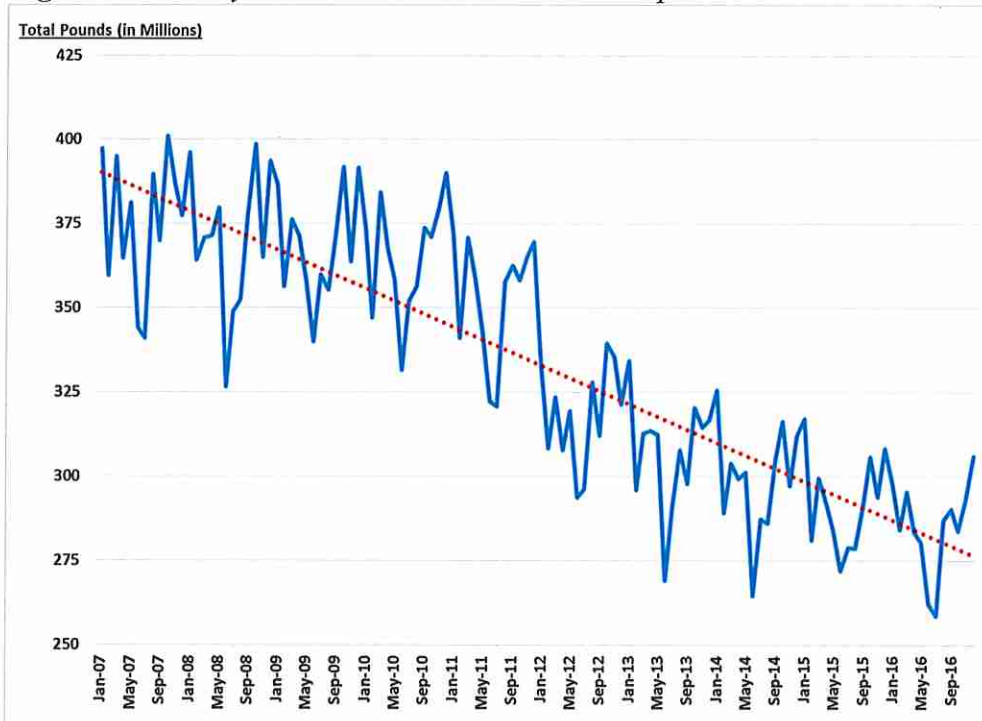
Effectively what this request would do is increase the reserve supply in Federal Order 30. While it may be the goal of an individual Federal Order to ensure that every cwt of milk that wants to be pooled, can be pooled – clearly, the Class I market does not require an increase in the reserve milk supply. More to the point – what purpose does a Federal Order with a 7.5% shipping percentage truly have?

Requested Change to Order Language is a Band-Aid Fix to a Long-Term Industry Problem

On a national level, U.S. milk production has experienced dramatic growth over the past 10 – 15 years. In 2016, the United States produced 212.4 billion pounds of milk which represents an increase of approximately 14.5% compared to just a decade ago. To put this gain over the past decade in perspective, milk output in the U.S. has increased by 26.8 billion pounds. According to current USDA estimates, U.S. milk production is expected to increase ~2.3% year-over-year in 2017. The increase in U.S. milk production has been especially pronounced in recent years in the Midwest, Mideast and Northeast. While U.S. milk production has increased exponentially in recent decades the same, unfortunately, cannot be said for Class I sales. Between 2007 and 2015 (the last year in which USDA-ERS data is available) – total U.S. fluid milk sales declined 8.5% to 49.9 billion pounds.

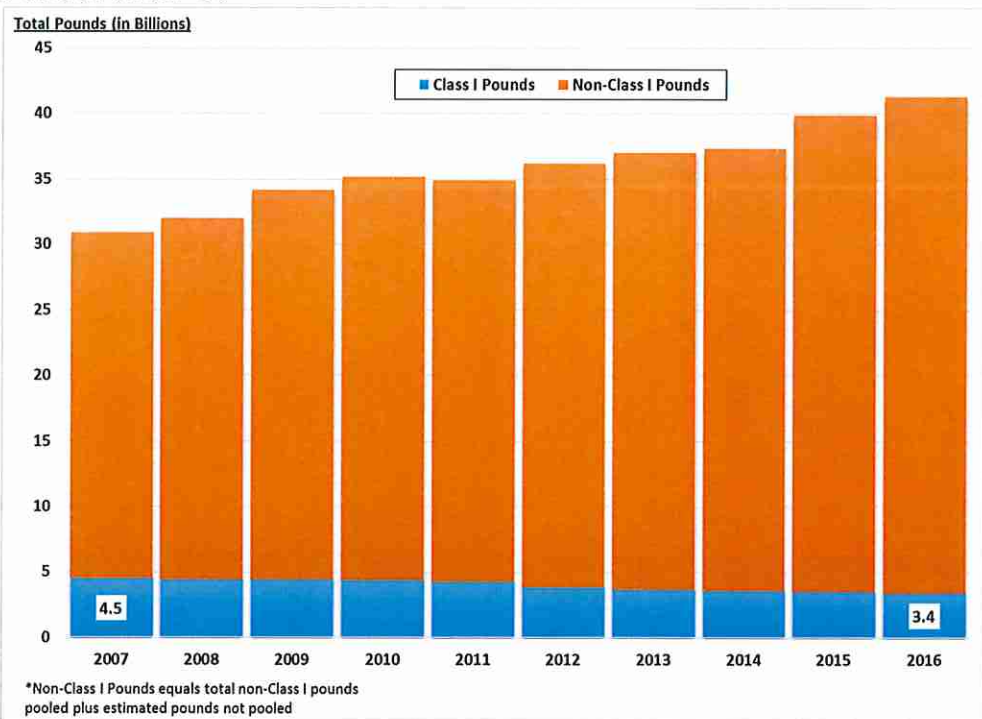
Looking specifically at Federal Order 30, the trends are very much in-line with those experienced nationally. Annual Class I receipts in Federal Order 30 have declined by slightly more than 1 billion pounds between 2007 and 2016.

Figure 1: Monthly Federal Order 30 Class I Receipts: Jan 2007 – Dec 2016



At the same time the total amount of milk in the Order, both pooled and estimated to be not pooled, increased by over 10 billion pounds over that same time period.

Figure 2: Annual Class I Receipts and Growth in Milk Supply (both pooled and estimated not pooled) in Federal Order 30



Given the trends, it is clear that the change that the Cooperatives are requesting would merely be a short-term fix to a long-term issue. Adjusting the shipping percentage to 7.5% may allow for more milk to be pooled on the order today. The long-term erosion in fluid milk demand – a trend that is very unlikely to change – coupled the milk production trends in Federal Order 30, a 2.5% reduction in the shipping percentage will not solve the issue. While it is not a trend we as a fluid milk company like to see, fluid milk consumption will likely continue to decline in the years ahead. By not addressing the root cause of this issue which is the decline in fluid milk consumption, we will continue to face this exact issue in the years ahead.

Data Fails to Clearly Support UMMA and CMPC’s Request

In their request, UMMA and CMPC discuss the relationship between “actual” delivered percentage when compared to the total pooled and estimated depooled milk, which they termed the “full pool.” This comparison is a red herring. Looking at the Federal Order 30 pool data does not clearly indicate that milk which wants to be pooled is kept out of the pool as a result of the 10% shipping percentage. In months in which the volume of milk de-pooled increased in 2015 and 2016, there was a clear economic rationale for it to occur.

Typically, the first sign of disorderly conditions in an individual Federal Order is fluctuations in over-order premiums. This occurs when milk struggles to find a home. With respect to Federal Order 30, there have been no notable changes in premiums.

Regulated Minimum Class I Prices Too High

While the request focuses on increasing the size of the pool, Dean would prefer to seek solutions which provide stability to the Class I market. A steady Class I market would be a significant benefit to the entire Order. Maintaining a high Class I price through differentials and the ‘higher-of’ provision negatively impacts fluid milk sales. In fact, in low Class I utilization Orders, like FO 30, these two instruments are more about price enhancement than it is about ensuring orderly marketing.

The current Class I differential values in Federal Order 30 are in need of review. According to the FO Reform Proposed Decision:

“The \$1.60 minimum differential level proposed is perceived to be the lowest value necessary under present supply and demand conditions to maintain stable and viable pools of milk for Class I use in markets that are predominantly manufacturing oriented (Fed Reg 63, P.4909 (1998)).”

Based on this rationale alone, it would appear that under present supply and demand conditions in the order, Class I differential values are too high. There is more than enough milk available to meet the demands of Class I facilities. So what costs all went into the Class I differential cost build-up?

As outlined in the Federal Order Reform decision there are three components that went into setting the base \$1.60/cwt Class I price differential in the FO system. The first portion of the differential cost build-up is around producer milk maintaining Grade A status. At the time it was implemented it was estimated to be worth ~\$0.40/cwt. An additional portion of the differential cost reflected, “the marketing costs incurred in supplying the Class I market. These marketing costs included such things as seasonal and daily reserve balancing of milk supplies, transportation to more distant processing plants, shrinkage, administrative costs, and opportunity or “give-up” charges at manufacturing milk plants that service the fluid Class I markets (Fed Reg 63, P.4908 (1998)).” USDA at the time estimated that this cost bucket accounted for ~\$0.60/cwt of the base Class I differential value. The final portion of the Class I differential cost build-up centers around competitive factors in the market place (i.e. premiums). USDA added an additional \$0.60/cwt to the base Class I differential in order to “reflect approximately two-thirds of the actual competitive costs incurred by fluid plants to simply compete with manufacturing plants for a supply of milk (Fed Reg 63 P. 4909 (1998)).”

Given the rationale for the base Class I price differential, it is increasingly hard to justify any of these purported higher cost components. Given the fact that nearly all milk in the U.S. today is Grade A, why should Class I handlers alone be responsible for paying producers to maintain their Grade A status? It seems particularly problematic that USDA saw fit to add a competitive premium component to the Class I differential. Dean feels strongly that any type of over-order premium should be negotiated between buyers and sellers of milk and does not serve any goal beyond price enhancement in being included in the regulated minimum Class I price build-up as it is today, especially in a market that is already oversupplied relative to Class I.

Reducing the supply plant shipping percentage, as requested by UMMA and CMPC, would likely lead to a reduction in blend prices in Federal Order 30 due to an increase in non-Class I milk in the pool. If one assumes that 2.5% more non-Class I milk is added to FO pool and that all of that milk is priced at the base zone differential for the Order (\$1.80/cwt), the pool value would decline by \$0.0450/cwt. On the other hand if the Class I utilization in Federal Order 30 was 10.0% and the Class I differential was reduced by \$0.30/cwt the impact to the pool would only be a reduction of \$0.0300/cwt. Details of this calculation can be found in Table 1.

Table 1: *Pooling Impacts from Increased Pool Volume and Decreased Class I Differential*

	% Change	Change in Value (\$/cwt)	Total Impact to Pool (\$/cwt)
Increased Milk Volume in Pool	2.5%	\$1.80	(\$0.0450)
Decreased Class I Differential	10.0%	(\$0.30)	(\$0.0300)

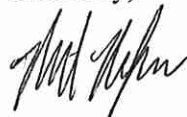
As a result of reduced Class I volumes there has been a greater need for non-Class I plant assets. Government regulations with respect to minimum Class I price setting have, in our opinion, helped lead to inefficient capital allocation with respect to plant investment decisions. If changes to the Class I pricing structure could help stabilize the Class I market why are we simply focused on reducing the shipping percentage?

Conclusion

Let's be clear about what request that UMMA and CMPC has submitted represents. It is merely a short-term Band-Aid fix to what is a significant long-term issue in the Federal Order system. Adopting the request will actually result in a lower blend price and negative impacts on the Class I market. The request before the Market Administrator now is not the first request to be made to an MA with respect to shipping percentages in recent years (shipping percentages have been adjusted in both the Mideast and Northeast), and given the trends in fluid milk demand both in the U.S. and FO 30, will not be the last. At some point the industry must stop focusing in on the short-term issues and must address the long-term structural issues facing the U.S. dairy industry. Dean feels strongly that that day is certainly now. The request should be rejected.

Thank you for your consideration.

Sincerely,



Rob Blaufuss
Senior Manager, Dairy Risk Management and
Economics