

UNITED STATES DEPARTMENT OF AGRICULTURE
BEFORE THE SECRETARY OF AGRICULTURE

In re:	)	Docket Nos. AO 14-A69, <i>et al.</i>; DA-00-03
Milk in the Northeast and	)	
Other Marketing Areas	)	
	)	

COMMENTS OF AGRI-MARK DAIRY COOPERATIVE

The following comments regarding the proposed rule and recommended decision for milk in the Northeast and Other Marketing Areas issued on October 25, 2001 are filed on behalf on Agri-Mark Dairy Cooperative. Agri-Mark is a Capper-Volstead qualified cooperative with more than 1350 members whose farms are located in New York State and the six New England states. Our member milk is pooled under the Northeast Federal Order and we operate plants that are regulated under that order. We participated in the original hearing in May of 2000 and presented testimony and evidence.

Agri-Mark takes strong exception to the conclusions and actions proposed by USDA in the latest recommended decision. We believe it will create serious economic and marketing problems for both producers and handlers in the marketing area as well as lead to disorderly marketing.

UNIQUE PROBLEMS OF END-PRODUCT PRICING

When USDA changed the basis of class pricing from a competitive price based system like the former Minnesota-Wisconsin and Basic Formula price series to an end-product pricing system, they created a pricing box for which there is no escape for regulated handlers. Under the former competitive based prices, unregulated handlers would determine the price paid to producers for their milk based upon the market price for cheese less the return each handler needed to cover their costs, profits and other factors. If costs escalated, the pay price to producers would usually be less at any given cheese price. If competition for milk supplies or other factors pushed milk prices up, handlers in turn would attempt to raise dairy product prices to compensate. In either case, handlers would have a possible outlet to adjust the difference between the price they paid for their raw product and the price they received for their manufactured product.

That outlet disappeared when USDA implemented end product pricing for Class III and IV products under the Orders. End product pricing sets the minimum prices for Class III and IV milk based upon the market prices for cheese/whey and butter/powder respectively. The combination of end product pricing, administratively fixed yields and manufacturing costs and minimum pricing creates an enclosed box around prices.

USDA collects actual market surveyed prices of cheese/whey and butter/powder and then subtracts out the administratively determined costs of manufacturing the products coupled with the administratively set yields of each product from a hundredweight of milk in order to set a farm milk price for each use of milk. That class milk price is a minimum, which must be paid by handlers. If a handler has costs or yields that differ from those set by USDA, he has the option to pay more for the milk but not less. Since USDA used an average manufacturing costs in their pricing formula, by definition half the handlers had costs above those set by USDA. In addition, since USDA sets the manufacturing costs at a fixed level based upon a certain point in time, any increase in costs, for fuel or other factors, are not accounted for by USDA. Since the class price is a minimum and the manufacturing costs are fixed by USDA, a handler's only way to be compensated for higher than average costs or for rising costs is to raise the price of his final product. However, the higher product price is then used by USDA to determine a new and higher class price. Handlers are essentially trapped in a box that they can not escape from.

This is particularly onerous when (1) USDA fails to include all the legitimate costs incurred by handlers from the point they receive producer milk to when they ship their final manufactured product and (2) USDA uses yield and price factors that are unrealistic. These problems will erode the economic viability of manufacturing plants under the Orders. This is even a more serious problem when handlers have an alternative to produce their products in areas like California where their milk costs are substantially less. If such plants cease to operate as a result of the USDA actions, producers lose the outlets for their milk and the marketing of milk becomes disorderly.

Federal Orders set and enforce minimum prices for milk. Handlers have always been free to pay more when competitive conditions warrant it but they can not pay less. In this decision and their prior decision leading up to this decision, USDA appears to be moving away from the principle of setting a minimum price to setting "the price" in an attempt to capture not a minimum value of milk but all the value of milk used to make a dairy product. However, since the value of milk varies by handler according to his costs, yields and price for his final product, determining "the price" is an impossible task. Any average price used as "the price" clearly will over estimate the value of milk for half the regulated handlers.

A true minimum price will allow most, if not all, handlers the opportunity to cover their costs and offer competitive premiums to the extent their costs and the competitive environment dictates. There is no way to correct for a minimum price set too high while a competitive marketplace can correct for a minimum set too low.

HANDLER COSTS FROM FARM TO FINAL PRODUCT

If USDA is going to use a survey of actual prices received for dairy products to set a minimum price for the milk used to manufacture those products, then USDA must account for all the costs incurred by the handler from the farm to the placement of the final product on the shipping dock. The price a handler receives for his product is normally the only way a handler can be compensated for the costs he has incurred. If USDA uses the surveyed price, less costs to determine the class milk price, but then leaves some costs unaccounted for or underaccounted for, where will the handler get the revenue to pay those costs?

The proposed decision discusses the term gross margin to imply that a handler has some revenue beyond the price reflected in their survey to cover costs. While some handlers do receive prices for their products above those reported in the survey, those higher prices are “value-added” prices. That “added value”, whether it be from product differentiation such as aging or flavoring or additional services applied to the product such as cut and wrap or marketing/promotion, comes with a cost. Since USDA excludes any of those value-added costs in their manufacturing allowance, they can not then imply that there is additional revenue available from those value-added products. Handlers make investments to create added value to their products in order to make higher returns and earn an adequate return on those investments.

The manufacturing costs used from the CDFA costs study and applied to the RBCS study, incorporated a return on investment that was based on the undepreciated book value of the plant and equipment and the prime interest rate. From a practical point of view, a plant and its equipment could never be replaced at today’s higher costs for the book value set many years ago, even not withstanding undepreciated book value. In addition investors would not incur the risk of investing in new facilities if their projected return were the prime interest rate at best. Both realistic replacement values and rates of return on investment must be incorporated in the manufacturing costs if handlers are expected to invest in new Federal Order Class III and IV facilities in the future.

As discussed in my testimony, Agri-Mark participated in the RBCS survey on a regular basis. However we never used it to review or even consider what our average or even total costs of manufacturing were. We had our own internal accounting procedure for that purpose and only used various costs components of the survey to compare selected costs items with similar items in plants operated by other handlers. Dr. Ling stated in his testimony that the survey was not designed for the purpose of determining make allowances (p. 73 of transcripts), and neither Agri-Mark nor, to best of our knowledge, other cooperatives use it in such a manner. Agri-Mark participated in the NCI study because of the exact problems we saw with the RBCS data. Dr. Ling did a good job with the data he had to work with, but in our case, and probably others, that data was not intended to represent total costs.

The proposed decision includes a manufacturing costs allowance of \$.165 per pound of cheese as the basic manufacturing costs yet Agri-Mark testimony (p. 1485) showed that our costs averaged \$.184 per pound at our Middlebury, Vermont cheddar cheese plant. This cost excludes both procurement costs (which will be discussed later) and a realistic return on capital deployed. This plant employs 107 employees of the 284 employees on Agri-Mark’s payroll. The plant is about an average size for the Northeast. It is not used to balance short milk supplies. However it is a small plant when compared to some in the California price survey and even some in the RCBA survey. This points out the discrimination inherent in USDA’s use of an average manufacturing costs relative to smaller businesses.

Smaller business’ tends to have smaller plants which in turn, tend to have higher costs of manufacturing since they can not take advantage of economies of scale in operations or purchasing. USDA should take that into consideration but has not done so. We believe that the \$.165 manufacturing costs allowance by USDA is too low and the department must re-open the

hearing to collect further data on the correct costs. In addition, USDA should internalize a procedure with the Order provisions which allows those costs to be recalculated on a regular basis to account for any changes in significant cost items such as energy or interest rates.

USDA did not consider a major costs item that all Class III and IV handler must incur as part of their normal business. The costs of procuring milk from farms were not considered. On transcript page 69 of Dr. Ling's testimony, he states that his RBCS study specifically excluded milk procurement costs. Further in his testimony (page 77), Dr. Ling noted that procurement costs are necessary costs but were excluded from his methodology. Procurement is a real cost and is either incurred by the handler who picks up milk directly from farmers or is charged to handlers who purchase milk from cooperatives or other handlers. This cost includes producer payroll, farm inspection and testing work as well as transportation and marketing of raw milk for plant balancing purposes. This cost ranges from \$.20 to \$.30 per cwt. and even higher in some areas. Both the Class III and IV pricing formulas should include these real costs

YIELD ISSUES

Any yield factor used by USDA must account for the loss of milk components that occur from the time milk is picked up at the farm to when the manufacturing of the final product is complete. This milk component loss is referred to as shrinkage.

Milk and milk components are lost when milk sticks to the farm bulk tank, the trailer tank and the entire array of pipes and equipment at the plant. If shrinkage did not occur then farmers, milk truck drivers and plant operators would not have to clean and rinse their equipment. Obviously, no dairy products are yielded from components that are lost in this manner.

Agri-Mark agrees with the International Dairy Foods Association (IDFA) in their comments that USDA is wrong in its contention that shrinkage has already been accounted for regarding class III and class IV in the decision. In particular, the RBCS studies, which Agri-Mark participated in, did not take shrinkage into account as noted by IDFA.

The existing allowance for shrinkage under the Orders is a value allowance, not a volume allowance. That shrinkage provision allows handlers to account for any lost milk or milk components at the lowest class value, however the volume of the milk lost must still be paid for. This provision primarily benefited Class I handlers so they would not have to pay the full Class I price for milk that never reached the packaging room. Such a value allowance has virtually no meaning for the low value Class III and IV handlers.

Yield factors set forth in the recommended decision rely greatly upon the testimony of Dr. David Barbano. While Dr. Barbano testified that his yield formulas did not account for shrinkage, he also testified to the considerable component losses between the farm bulk tank and the plant receiving silo, between the receiving silo and the vat, churn or dryer, and finally between the vat, churn or dryer and the final product.

Agri-Mark urges USDA to account for shrinkage of all components in both Class III and IV at the rates discussed by IDFA. Agri-Mark further agrees with the IDFA comments that USDA

should reduce the cheese yield factor from 1.405 to 1.383. The 1.405 yield is overstated due to both the methodology used to calculate it and the exclusion of farm to vat losses of components.

PRICE AND VALUE ISSUES

At the initial hearing in May 2000, Agri-Mark originally supported using three cents as an acceptable and reasonable spread between the block and the barrel price. However we did so based upon historic block and barrel cheese price differences at 39% moisture. When that moisture content is adjusted to 38%, the price difference falls to 1 cent. We believe that USDA should therefore reduce the three cents to one cent when calculating the weighted average cheese price used in the protein formula. Once again, we agree with the argument put forth by IDFA in its comments.

In the recommended decision, USDA states that “[s]ince all the butterfat used in Class III is to be priced on the basis of its value in butter, an adjustment must be made to account for the difference in butterfat values between cheese and butter.” USDA goes on to conclude that this adjustment is only necessary for the 90% of butterfat which is recovered in the finished cheese.

However, the same line of analysis should be followed to account for the difference in butterfat values between sweet cream used to make Grade AA butter and whey cream. In fact, USDA later in the recommended decision applies a method to value whey butter by subtracting 9 cents per pound from the Grade AA butter price. USDA clearly recognizes that whey cream has a lower value than sweet cream used to make Grade AA butter.

Because, as USDA itself points out, the hearing record does not support requiring a separate Class III butterfat price, this adjustment for the difference in the value of butterfat in Grade AA butter and whey cream must be accounted for in the protein price formula. We support the adjustment put forth by IDFA in their comments.

FARMER INCOME AND OUTLETS FOR MILK

As a dairy farmer owned and controlled cooperative, farmer income is the number one priority for the cooperative. While the USDA proposed rule may appear to raise Order prices initially, we believe that will likely result in lower prices to farmers over time. USDA prices are minimums and many handlers who manufacture cheese and butter/powder pay “over-order” premiums in order to maintain a supply of milk. Under the USDA proposal, any such premiums will be the first to disappear as manufacturers struggle to survive. When those premiums fall, Class I and II processors will no longer need to pay competitive premiums to farmers in order to keep their supply of milk and income will fall on all milk.

Once premiums are eliminated but the price distortion problem created by USDA still exists, manufacturers will still face an economic squeeze and likely relocate their operations or cheese purchases, if possible. Cooperatives will be forced to find more distant outlets for the displaced milk or operate the plants themselves at a loss. Cooperatives would then be forced to pay producers prices below the minimum set by the Order. One way or another, higher Class III and IV prices will not benefit producers if they can not be sustained in the marketplace.

Note however, that Class I and II handlers do not experience the same problem as Class III and Class IV manufacturers because the price of Class I and II final products are not used to calculate their minimum class prices. Those handlers can raise their product prices without having to worry that their actions will merely raise their input costs further. However even with that consideration, we have always strived to make sure that under regulatory plans such as Compact, local Class I handlers were kept competitive among themselves and with their competition outside the area. To do otherwise would just serve to drive local Class I processors out of business. We believe that USDA must give similar consideration to Class III and IV handlers.

The proposed rule would have serious economic consequences relative to the competitive relationship between Federal Order Class III and IV handlers and similar handlers regulated in California. Under the proposed rule, California handler would have had a \$.62 per cwt. Class III price advantage over Federal Order handlers during the past three years (1999-2001). However a recent change in the California manufacturing costs allowance would boost that price advantage to \$.68 per cwt. or almost seven cents per pound of cheese. This difference represents several million dollars per year to average size cheese plant in the Northeast. With older plants in the Northeast already having higher manufacturing costs than their larger and newer peers out west, this price distortion would provide a huge incentive to relocate their operations to California.

California's milk production of more than 33 billion pounds annually has led the nation since it surpassed Wisconsin in 1993. The state now ranks first in the nation in production of fluid milk, butter, ice cream and nonfat dry milk powder. California also produced 1.5 billion pounds of cheese in the year 2000 and is only behind Wisconsin in total cheese production. However with California cheese production up 62% in the past five years (compared to 23% nationally) and more huge cheese plants being built, it is only a matter of time before Wisconsin falls to second place in that category too. Cheese companies have already shut down plants in other areas of the country and turned to California to take advantage of the plentiful milk supplies and lower milk prices. The latest proposed Class III increase by USDA will aggravate that problem even further.

USDA must take in consideration the competitive situation between California and Federal Order Class III and IV plants. The Orders must not give handlers an economic incentive to leave and relocate elsewhere. That consideration goes to the very heart of the disorderly marketing issue and to the net prices received by farmers.

The USDA decision particularly hurts dairy farmers who have taken risks and invested in their own cheese plants and cheese companies in order to capture income in the marketplace. Agri-Mark farmers have more than \$75 million invested in their Cabot Cheese business. They have grown sales dramatically in the past five years and now Cabot cheese is sold throughout the country – including in California. Any unwarranted increase in Class III milk prices takes money from those farmers who have invested in the future and attempts to redistribute it to other farmers. As a farmer cooperative which uses its local member milk to make our award-winning cheeses, we can not relocate to California – we can only stand-by helplessly while a USDA decision makes our cheese uncompetitive and our sales fall. USDA should be encouraging

farmers and their cooperative to seek more income from value added products in the marketplace, not penalize them for doing so.

In summary, Agri-Mark opposes implementation of the recommended decision. We believe the hearing should be re-opened to provide updated information and re-consider all the issues brought up in these comments. If a decision is implemented it must contain all the adjustments discussed in these comments, including shrinkage yield adjustments for BOTH classes of milk and procurement costs adjustments for BOTH classes.

Respectfully submitted,

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