

UNITED STATES DEPARTMENT OF AGRICULTURE
AGRICULTURAL MARKETING SERVICE
Dairy Programs

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FEDERAL MILK MARKETING ORDER)
NATIONAL CLASS III and IV)
PRICE FORMULA HEARINGS)

Docket No. AO-14-A69, etc.
DA00-03

POST-HEARING BRIEF
ON BEHALF OF KRAFT FOODS, INC.

1. INTRODUCTION

The Federal Milk Marketing Order reform process which began with a mandate of Congress in Section 143 of the 1996 Farm Bill, 7 U.S.C. § 7253, and concluded three years later with a final decision and implementing regulations of the Secretary of Agriculture, 64 Fed. Reg. 16025 (April 2, 1999) and 64 Fed. Reg. 47897 (September 1, 1999), effected a radical but unavoidable change in the process by which minimum prices for farm milk used to produce butter, powder, and cheese (Class III and IV products), are fixed.

For the previous four decades, minimum milk prices were based on average competitive values of unregulated milk sold for manufacturing purposes. The margins of milk manufacturers between milk costs and product price, like prices paid to dairy farmers, varied month to month and year to year.¹ The use of product price formulas in the final reform decision turned this

¹Hearing Ex. 25, Table 1, for example, presented by Geoff VandenHeuvel, calculated imputed per hundredweight cheese conversion margins between the regulated basic formula price and the reported CME/NCE market price as ranging from minus \$1.19 to plus \$3.34 on a monthly basis.

process around. Price rules now attempt to find an imputed competitive price for milk based on product price surveys and a fixed manufacturing margin.

The new approach to regulated Class III and IV prices continues to adjust producer revenue and farm milk prices based on changes in marketplace and competitive conditions. Significantly, however, it disables manufacturers from continuing to make month to month competitive adjustments in manufacturing margins. Rather, as applied to manufacturers, it replaces competitive flexibility with regulatory “rigidity,” as one economic expert observed. Sue Taylor, Tr. 1719. Because the manufacturing allowance is fixed by regulation, manufacturers can no longer recover increased costs, added producer premiums, or temporary losses, by raising product prices because such product price increases result in a penny for penny ratchet of regulated raw milk prices. Yonkers Tr. 260-61.

Some well-intentioned farm advocates see the Secretary’s new role in regulating manufacturer margins as an opportunity to increase farm prices simply by adjusting or disallowing some manufacturer costs, by toying with yield factors, by selective limitation of product price surveys, or by adjustment of other economic components which produce the ultimate manufacturing margin. Neutral industry analysts, however, have cautioned that fixing a margin which is too small to recover costs plus a reasonable return on investment to plant owners presents a far greater risk to the dairy industry than fixing margins which are too large.² Mark Stephenson, Ex. 29, Tr. 1004-6; Final Milk Order Reform Decision of the Secretary, 64 Fed. Reg. 16025, 16097 (April 2, 1999)(“If the make allowances are established at too low a level,

²Other experts agreed with Dr. Stephenson that a too-low allowance will imperil investment and manufacturing capacity, while a more generous allowance will self-correct in the marketplace. Yonkers, Tr. 255-262; Dryer, Tr. 1324; Taylor, Tr. 1719-20.

manufacturers will fail to invest in plants and equipment and reduced production capacity will result.”).

As described below, the fixing of a manufacturing margin which does not allow recovery of costs *and a reasonable return on investment* is not only bad economic and regulatory policy. It is also unlawful.

Because regulation of plant profitability, by providing a manufacturing allowance, is relatively new to the Federal Milk Marketing Order Program, it is useful to examine judicial standards by which the lawfulness of such regulated rates must be judged.

II. THE STANDARD FOR CONSTITUTIONALLY REASONABLE RATES, AS ARTICULATED IN *FEDERAL POWER COMMISSION v. HOPE NATURAL GAS CO.*, 320 U.S. 591 (1944), REQUIRES RECOVERY OF ALL REASONABLE OPERATING EXPENSES AND RETURN ON INVESTMENT.

The seminal decision of the U.S. Supreme Court articulating standards for government ratemaking authority is *Federal Power Commission v. Hope Natural Gas Co.*, 320 U.S. 591 (1944). In that case, Hope Natural Gas complained that the Commission should have adopted an eight percent rate of return on investment rather than six and one-half percent. Rejecting this contention, the Supreme Court instructed:

From the investor or company point of view it is important that there be enough revenue not only for operating expenses but also for the capital costs of the business. These include service on the debt and dividends on the stock ... by that standard the return to the equity owner should be commensurate with returns on investments and other enterprises having corresponding risks. That return, moreover, should be sufficient to assure confidence in the financial integrity of the enterprise, so as to maintain its credit and to attract capital.

* * * * *

Rates which enable the company to operate successfully, to maintain its financial integrity, to attract capital, and to compensate its investors for the risks assumed certainly cannot be condemned as invalid even though they might

produce a meager return....

320 U.S. at 602, 605.

The standards expressed in *Hope* have been applied and reaffirmed in the intervening six decades, and are by no means limited to gas price regulation. In *Duquesne Light Co. v. Barasch*, 488 U.S. 299, 310 (1989), the Supreme Court applied *Hope*'s financial integrity and return on investment standards to uphold Pennsylvania state electric utility regulation. The court also observed that a rate which "does not afford sufficient compensation" is unlawfully confiscatory, in violation of the Fifth Amendment. 488 U.S. at 307-308. Applying *Hope* principals, the Department of Interior, adopts Standard and Poor's BBB bond rating as the reasonable rate of return on undepreciated capital investments in certain royalty rate regulation. 30 C.F.R. § 206.718(b)(2)(v); 30 C.F.R. § 206.55(b)(2)(v).

The Federal Communications Commission, likewise, has recognized the importance of *Hope* standards in achieving "a proper balance of regulatory goals by allowing a carrier to 'maintain its credit and to attract capital.'" 60 Fed. Reg. 28542 (June 1, 1995).

The Federal Maritime Commission has also acknowledged the "landmark" status of *Hope* financial integrity in the exercise of its ratemaking responsibility:

Two landmark Supreme Court cases [including *Hope*] establish that investors in companies subject to rate regulation must be allowed an opportunity to earn returns sufficient to attract capital, comparable to investments in other firms having the same amount of risk, and that revenues must not only cover operating expenses, but capital costs as well. The economic rationale for setting the allowable rate of return of a regulated company equal to its cost of capital is that in the long run the regulated firm's customers will pay the lowest cost for service while at the same time the company's earnings will be sufficient to attract capital so that the company is able to provide the customers' desired level of service.

60 Fed. Reg. 46047, 46049 (September 5, 1995).

While *Hope* and its progeny mandate recovery of reasonable costs and return on investment as a condition of lawful ratemaking, *Hope* is not at all dogmatic about how a reasonable rate is achieved.

[Ratemaking agencies are] “not bound to the use of any single formula or combination of formulae in determining rates. Its ratemaking function, moreover, involves the making of ‘pragmatic adjustments’ (citation omitted) *** [I]t is not theory but the impact of the rate order which counts. If the total effect of the rate order cannot be said to be unreasonable, judicial inquiry is at an end. The fact that the method employed to reach that result may contain infirmities is not then important.

320 U.S. at 601-602. This aspect of *Hope*, allowing regulatory flexibility in ratemaking methodology, also continues to govern agency proceedings. 64 Fed. Reg. 8356 (February 14, 1995)(Department of Energy, Request for Comments on Alternative Pricing Methods, containing an instructive narrative on “The Applicable Legal Standards”).

It is permissible for a constitutionally reasonable rate to result from disallowing or disregarding one cost factor if a combination of other factors permits cost recovery and return on investment. The “overall impact” of the rate, not the minute details of its component parts, is the proper measure of constitutional reasonableness. *Duquesne Light Co.*, 488 U.S. at 311.

III. APPLICATION OF JUDICIAL RATEMAKING STANDARDS TO REGIONAL AND NATIONAL RATES.

In its early years, the Federal Power Commission, like many other ratemaking authorities, established regulated rates for single companies or single facilities. As a result, the FPC ratemaking process became hopelessly backlogged. In the early 1960's, the FPC experimented with regional “area” rates applicable to multiple facilities and companies. In an instructive narrative of legal history, the FPC traced the precedent for regional ratemaking in a number of industries, including state (*Nebbia v. New York*) and federal (*United States v. Rock Royal Coop.*)

milk pricing regulation. 34 FPC 159, 176-180 (1965). In fixing the area-wide rate, like the Secretary of Agriculture in fixing handler manufacturing allowances, the FPC employed regional and national composite cost data. Further, holding true to the standard of *Hope*, the FPC allowed a twelve percent return on investment, plus an additional return on working capital. 34 FPC at 200-206. Finally, recognizing that an area-wide rate could work hardship on individual producers, the agency allowed petitions for rate exemption under special circumstances. 34 FPC at 225-226.

The FPC's regional ratemaking experiment was affirmed by the Supreme Court in *Permian Basin Area Rate Cases*, 390 U.S. 747 (1968). While disclaiming the notion "that maximum rates computed for a group or geographical area can never be confiscatory" (*id.* at 770), the court sustained the FPC's area rates because they ultimately conformed with *Hope* standards. *Id.*, 790-91, 808.

The FPC later expanded area rates to national rates, which also found judicial approval, applying the *Hope* financial integrity and net effect standards. *Mobil Oil Exploration v. United Distribution*, 498 U.S. 211 (1991); *Shell Oil Co. v. Federal Power Commission*, 520 F.2d 1061 (5th Cir.), cert. Den. 426 U.S. 941 (1976).³

³The 5th Circuit in *Shell Oil* approved a national rate "with some misgivings," because its adverse impact on individual producers under *Hope* standards were difficult to measure. It observed, however, that producers could avoid a confiscatory and inadequate rate simply by avoiding exploration and development in high-cost, high-risk areas. The FPC rate also provided a generous return on investment (15%) and return on working capital, along with a hardship exemption procedure for rate relief. In the proceeding before the Secretary of Agriculture, milk manufacturers with existing facilities who may be subject to inadequate manufacturing allowances will not have similar opportunity for loss avoidance.

IV. SEVERAL PROPOSALS BEFORE THE SECRETARY CREATE GREAT RISK, IF NOT CERTAINTY, THAT A RESULTING MANUFACTURING ALLOWANCE WILL PRODUCE A CONFISCATORY RATE IN VIOLATION OF *HOPE* STANDARDS.

While *Hope* and its progeny provide administrative flexibility in reaching the bottom line for a regulated rate, the Secretary must bear in mind when fixing manufacturing allowances that the bottom line, however calculated, must account for costs, revenues, and manufacturing practices sufficient to produce a reasonable return on investment. This judicial imperative was embodied as regulatory policy in the Secretary's Final Milk Order reform rulemaking decision. 64 Fed. Reg. 16025, 16097-98.

It may be observed that differences between proposed manufacturing allowances amount to only mils or pennies per pound of finished product. For example, the cheese manufacturing allowance proposed by NMPF and the Select/Western States Producer Trade Association are 1.5¢ and 3¢, respectively, less than the 17¢ per pound cheese allowance proposed by IDFA. But where the return on investment incorporated in each of the proposals is only about one penny, there is precious little room to wiggle between a reasonable rate and a confiscatory rate.⁴ There is no room to simply ignore marketing or administrative costs, to tweak revenues imputed in price surveys, or otherwise to play with the formula to produce a targeted milk price instead of a reasonable manufacturing allowance.

⁴The Land 'O Lakes' witness testified that its aggregate return on investment for butter and NFDm was 1.2%. Schad, Tr. 1212. Whether measured by prime lending rate, the bond market, or other capital investment index, it is doubtful that this rate meets the *Hope* standard of a return on equity "commensurate with returns on investment in other enterprises having corresponding risks." 320 U.S. at 602. And while it may well be that some dairy companies have accepted a modest return on investment during historical periods when manufacturing margins were subject to competitive flexibility, it does not follow that the same modest rate should apply when margins are fixed with regulatory rigidity.

Manufacturing allowances incorporated in the proposals as part of “costs” are designed to produce a very modest rate of return. Other circumstances and components of the pricing formula, however, may through the back door or a side door cause the end result to be unreasonable rather than reasonable under *Hope* standards. These are illustrated, by no means exhaustively, below.

1. Regional Cost and Product Price Differences.

It is clear that national average manufacturing costs include both regions and individual plants with costs substantially greater than average. Although some plants may theoretically improve their efficiency, “it is not theory but impact of the rate order which counts.” *Hope*, 320 U.S. at 602. There are some cost differences, moreover, which can never be avoided. For example, fuel and energy costs, as well as labor costs, are greater in the northeast than in most other parts of the country. See Department of Energy, Energy Price Series (<http://www.eia.doe.gov/price.html>), and labor statistics (<http://stats.bls.gov/blshome.htm>); Wellington, Tr. 1485. Regionally-higher market prices for cheese in the northeast may or may not offset higher than average costs. In the West, average manufacturer margins may be squeezed under all proposals because competitive product prices make up the low end of survey averages. Taylor, Tr. 1721-22. Marshall, Tr. 1810, 1818. Again, if lower prices are offset by lower costs for energy, higher yield or other factors, the end result test of *Hope* will be satisfied, and a regionally-confiscatory rate will be avoided.

B. Imputed Product Yields.

Product yields, like plant costs, vary from plant to plant and region to region. There was much debate in the hearing concerning appropriate product yields to be included in the

manufacturing allowance formula because greater yields would produce greater imputed plant revenue and a higher producer price. Some witnesses, in hopes of producing a higher producer price, sought to attribute to manufacturing plants theoretical product yields, and theoretical fat or protein recovery, which many manufacturers do not now realize in actual operation. Of course, if actual yields are less than imputed yields, the resulting margin recoverable by the manufacturer is reduced. Again, the instruction of *Hope* that revenue impact, not revenue theory, is what counts. Actual yields, not theoretical yields, should therefore be employed in the formula.

3. Product Price Survey Overvaluation and Distortions.

Selective disregard of commodity prices in product price surveys may also indirectly reduce the manufacturing margin by imputing to the handler greater revenue for sale of the commodity than actually produced in the marketplace. Inclusion of product prices for all package sizes of cheddar cheese (40-pound blocks, barrels, and 640-pound blocks), and careful accounting for market price differences in these products, would tend to avoid a price survey erosion of the penny allowed on cheese for return of investment. Product price overvaluation, producing the same result, is also apparent in proposals which would attribute to whey cream the same value as sweet cream used to produce butter where the undisputed record reveals that the market value of whey butter is less than that of Grade AA butter. See, Reinke, Tr. 1040-41, 1058; Taylor, Tr. 1733-35.

4. Milk and Milk Component Manufacturing Losses.

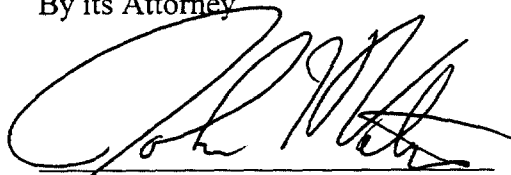
Milk handlers must account for the value of milk and milk components from the farm gate. It is indisputed and inevitable that some milk components for which handlers must pay are lost between the farm gate and the finished product package. Exs. 19-20; Lenehan (Ecolab,

Inc.), Ex. 35, Tr. 1251-56 (in-plant loss of milk components discharged in waste water averages 2.3% of components received at the plant). No product revenue is received for lost milk components, whether the loss occurs before the milk gets to the plant, during manufacturing, or before the finished product is packaged. However, failure to deduct the value of lost components, by pretending that the components are included in a product package and generate revenue, would correspondingly reduce the regulated margin available to the manufacturer. There is clearly not enough room in the one penny ROI to take an ostrich-like approach to any component of plant costs or margins.

CONCLUSION

As to Class III and IV pricing, and associated manufacturing allowances, the Secretary's Final Milk Order reform rulemaking decision was clearly on the right track. With some minor adjustments as supported by testimony of Bob Yonkers, Kraft Foods, and other IDFA members, the formula recommended by the Secretary in 1999 is eminently defensible on the record of this proceeding.

Respectfully submitted,
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