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UNITED STATES DEPARTMENT OF AGRICULTURE

AGRICULTURAL MARKETING SERVICE

IN RE:)	
)	
MILK IN THE NORTHEAST AND)	
OTHER MARKETING AREAS;)	Docket Nos
PROPOSED AMENDMENTS TO)	AO-14-A74, et al.;
CLASS III / IV MANUFACTURING)	DA-06-01
ALLOWANCES)	
71 Fed. Reg. 67467 (Nov 22, 2006))	

LEPRINO FOODS COMPANY’S COMMENTS ON TENTATIVE FINAL DECISION

INTRODUCTION AND SUMMARY

The United States Department of Agriculture (“Department”) conducted a Hearing January 24 - 27, 2006, in Alexandria, Virginia and a reconvened Hearing September 14 – 15, 2006 in Strongsville, Ohio (collectively referred to as “Hearing”) to consider proposed amendments to the Class III and Class IV milk price formula manufacturing allowances applicable to all Federal Milk Marketing Orders (“Orders”). Leprino Foods Company (“Leprino”) presented testimony at the Hearing and submitted post-hearing briefs based upon the evidence at the

January and September Hearings. We offer the following comments on the Tentative Final Decision [71 Fed. Reg. 67467] that was published by the Department in this matter (“Decision”) and urge the Department to adopt the changes recommended.

The Department properly found that an emergency exists, that omission of a recommended decision is warranted, and that the Tentative Final Decision should be implemented on an emergency basis [71 Fed. Reg. 67487]. The need for relief for cheese makers is urgent. Costs have increased significantly from the base period of 1997 – 1999 that was used to establish the current make allowances. The fixed relationship between finished product prices and the Class III and IV formula milk prices limits the marketplace’s ability to adjust for these changes. Additionally, the margin problem resulting from the understated Class III make allowances is not isolated to manufacturers of cheddar eligible for National Agricultural Statistics Service (“NASS”) reporting. The vast majority of cheese produced in the United States would be considered commodity cheese and is priced relative to the CME cheddar block price. Given the interchangeability of cheese making assets, market forces drive the net economics of these cheeses to equilibrate with cheddar over time [Taylor, Tr Vol IV, page 284 – 287]. As a result, all commodity cheese makers are facing similar margin challenges.

In its further consideration of the facts in developing its final decision, Leprino urges the Department to correct the Decision by find the following based upon the Hearing Record:

- ◆ The make allowance for cheese should be set no lower than 20.77 cents per pound of cheese.
- ◆ The make allowance for dry whey should be set no lower than 20.32 cents per pound of dry whey.

The Department failed to reach these conclusions in the Decision due to numerous oversights of the Hearing Record and the misapplication of consistent sound policy judgment as follows:

- I. The Department inappropriately rejected the population adjustment of the Cornell Program on Dairy Markets and Policy (“CPDMP”) cheese survey.
- II. The Department recognized the impact of scale economies on plant costs but incorporated the California Department of Food and Agriculture (“CDFA”) cost studies without making an appropriate statistical adjustment.
- III. The Department selectively and inconsistently used the CDFA data across the commodities in the Class III and IV formulas.
- IV. The Department must adopt the CPDMP energy cost update.
- V. The market value-based approach to the return on investment (“ROI”) calculation in the CPDMP study results in an underestimation of plant manufacturing costs.

The following is further elaboration on these issues:

I. The Department inappropriately rejected the population adjustment of the Cornell Program on Dairy Markets and Policy (“CPDMP”) cheese survey.

The raw results of the stratified random sampling technique deployed in the cheddar cost study necessitates an adjustment in order to determined the costs of the population of cheese plants in the Federal Order. The statistical method

used by Dr. Mark Stephenson to identify participants in the cheddar cheese plant cost survey was a stratified random draw. This sampling method is well accepted as a superior method to be used in selecting a sample set within a population that has a significant range of size, but within which a relatively small percent of the population comprises a rather large percent of the outcome. In this case, several large cheddar plants produce a significant volume of total cheddar cheese. The methodology intentionally over samples the large plants since errors on that population could introduce significant errors in the overall result. In a simple draw, far fewer of these plants would be expected to be part of the population. The raw results from a sample population are representative of the sample set, and by the nature of the sample draw in the stratified random sample used in the cheddar cost study, disproportionately represent large cheddar plant. From a statistical standpoint, the stratified random sample result must be adjusted in order to estimate the overall result for the population, such as all cheddar plants in the Federal Orders.

The Department erroneously concluded that adopting CPDMP's population estimate for cheddar without similarly adjusting the cost studies for the other commodities would unfairly advantage cheese makers. Unlike in the cheese costs of processing survey, the sampling methodology utilized by the CPDMP in the butter and nonfat dry milk surveys consisted of simple draws. When a simple draw is used as the sampling technique, as it was used in the butter and nonfat dry milk surveys, the methodology itself does not intentionally bias the sample set by some type of size related group. Therefore, data obtained through simple draw surveys, such as that obtained in the butter and nonfat dry milk surveys, should be representative of the population, and not be adjusted.

Since the whey data was collected from a subset of the cheddar plants selected through the stratified random sampling technique, similar to the cheddar survey, the whey sample set should also be adjusted to the population. However,

CPDMP did not have the plant population data to perform that analysis and determine a population-weighted cost. This is an unfortunate shortcoming but it disadvantages cheese makers, not Class IV manufacturers, and should not be used as a justification for further disadvantaging cheese makers by rejecting the statistically necessary population adjustment for the cheddar cost survey.

II. The Department recognized the impact of scale economies on plant costs but incorporated the California Department of Food and Agriculture (“CDFA”) cost studies without making an appropriate statistical adjustment for the scale bias.

The Department recognizes that economies of scale are an important determinant of plant costs. In fact, the Department states that *“The CDFa data specifically establishes that economies of scale are evident for California processing plants for all four commodity types. The data demonstrate that plant size is a major determinant of plant costs, with larger plants having significantly lower per unit costs of processing than smaller plants... Demonstrable economies of scale as shown in the CDFa survey for California manufacturing plants and by the CPDMP study for manufacturing plants located outside of California meet the expectations of economic theory and provide evidence that the CDFa and CPDMP survey results are reasonable and comparable.”* [71 Fed. Reg. 67484].

A review of the cost studies reveals that the CDFa data for cheddar cheese represents significantly larger plants on average than is representative of the nation at large or the CPDMP study. Table 1 summarizes the cheddar plant sizes in the various studies compared with the national average plant sizes as reported by USDA in the 2005 Dairy Products Annual for 2004 production.

		Production (1,000 pounds)	Number of plants	Average per plant (1,000 pounds)
2004 U.S. Production (NASS, 2005 Dairy Products Annual, pp 2 - 4)				
	Cheddar	3,004,477	159	18,896
	American Cheese	3,738,826	178	21,005
CPDMP	Low Cost Group	710,275	8	88,784
	High Cost Group	253,303	8	31,663
	Total Sample	963,577	16	60,224
CDFA	Low Cost Group	628,560	3	209,520
	High Cost Group	188,508	4	47,127
	Total Sample	817,068	7	116,724

Table1. Average plant sizes in U.S. and in CPDMP and CDFA cheddar plant cost studies.

It is clear from this comparison table that, at an average plant size of 60 million (nearly triple the average size American cheese plant according to NASS), the CPDMP survey over samples large plants, as was the intent of the stratified random sample. But additionally, it is abundantly clear that the CDFA cost study is comprised of plants of even greater scale, on average 5.5 times the average size reported nationally by NASS. It is clear that, while the CDFA survey is representative of the scale of cheddar plants in California, it is not representative of the scale of cheddar plants in the balance of the country.

Leprino has a high regard for the CDFA cost studies. A staff of accountants whose primary responsibility is collecting and analyzing cost information completes the CDFA cost studies. The resulting cost studies are based on audited data compiled according to a consistent methodology. CDFA's cost studies have been fine-tuned through many years of data collection and use to support policy decision-making [Taylor, Tr Vol IV, page 289]. Prior to the existence of a more robust study relevant to the cost of manufacturing for plants

that are potentially regulated under the Orders, we also previously supported the use of the CDFA cost studies in combination with the RBCS cost study. However, now that the AMS-commissioned CPDMP cost study is available, we do not believe that the CDFA cost studies are necessary in the consideration of the make allowances under the Orders. In fact, given the scale bias in the CDFA cost study, they should only be used in the validation of the CPDMP study by comparing comparably scaled plants.

In fact, the Department seems to concur with this in the Decision. The Department stated: *“The CDFA plant cost data, considered in isolation, have somewhat limited utility for considering manufacturing costs for plants located in all FMMO areas because all of the plants are located in California... Because of the comprehensiveness of CDFA’s coverage and California’s importance to national dairy markets and dairy product manufacturing, the CDFA survey of plant manufacturing costs provides an important reference for considering and calibrating the costs of similarly-sized and operated plants located outside of California”.* [71 Fed. Reg. 67484 – 5].

In light of the significance of scale in driving costs and the significantly larger scale represented by the CDFA cost study, its only use in the setting of the Order make allowances should be as a calibration / validation instrument unless the Department has sufficient access to the data sets that it can combine the CDFA data with the CPDMP data and make the appropriate population adjustment on the combined data set.

III. The Department selectively and inconsistently used the CDFA data across the commodities in the Class III and IV formulas.

The Department’s selective and inconsistent use of CDFA data in the Decision is of great concern. The Decision uses CDFA data for all commodities except whey, dismissing the CDFA whey cost study without substantiation. Additionally,

the Department uses the mid-sized plant category for nonfat dry milk because it more closely resembles the average plant size for nonfat plants operating under the Orders, but does not employ a parallel methodology on cheddar, which suffers from the same scale issues as nonfat dry milk.

The Department’s dismissal of the CDFA dry whey survey as “*unreasonably high because California has only three dry whey processing plants where high cost plants appear to skew the costs dramatically*” [71 Fed. Reg. 67485] is not substantiated by any record evidence. And, in fact, a review of the data in light of the scale impact on costs noted above sheds some light on a significant factor contributing to the differences in cost between the CDFA and CPDMP cost studies.

		Production (1,000 pounds)	Number of plants	Average per plant (1,000 pounds)
2004 U.S. Production (NASS, 2005 Dairy Products Annual, pp 2 - 4)				
	Dry Whey, Human	948,915	37	25,646
CPDMP	Total Sample	568,736	12	47,395
CDFA	Total Sample	93,272	3	31,091

Table 2. Average plant sizes in U.S. and in CPDMP and CDFA whey plant cost studies.

Table 2 summarizes the average whey plant sizes in the U.S. according to NASS, in the CPDMP study, and in the CDFA study. Not surprisingly, since the CPDMP sample plants are a subset of the stratified random cheddar sample that was biased toward large plants, the average whey plant in the CPDMP survey is nearly double the national average whey plant size. However, with the predominance of large plants in California producing whey products other than

sweet whey, the three whey plants in the CDFA study represent average plant sizes closer to the national average. Once again, the importance of scale on plant costs is evidenced by the higher whey cost numbers on the smaller (but still larger than national average) whey plants that were surveyed in the CDFA cost study.

Another contributing factor to the difference in whey costs between the CDFA and CPDMP studies is that the CPDMP study includes plants that receive condensed whey from other plants. Consolidating whey from multiple plants cannot be done on a practical basis in milk sheds where distances between cheese plants is significant so it should not be considered the norm. Nonetheless, the inclusion of these plants in the CPDMP study lowers the average cost because the costs incurred in handling the whey at the source plant are omitted.

The CDFA whey cost study is sound. The whey cost data is collected under the same rigorous procedures as is used by CDFA to collect the costs for cheddar cheese, nonfat dry milk and butter. While the whey cost study has not been conducted for as many years as these other commodities, Exhibit 24 shows that the weighted average costs were nearly identical for the two years for which studies were available at the time of the Hearing. Subsequent to the Hearing, CDFA released their study of 2005 costs that, not surprisingly given rising energy costs, showed that whey costs had risen nearly two cents from 26.73 cents in 2004 to 28.51 cents in 2005. The logical consistency across three cost periods reinforces the soundness of the CDFA whey cost study. The Department described these procedures in detail during the Hearing [Reed and Krug, Tr Vol I, pages 152 – 219]. There was not a single concern or criticism raised in their testimony or cross-examination. No record evidence or logical argument exists that would support discarding the CDFA whey data if CDFA data is used for the other commodities.

IV. The Department must adopt the CPDMP energy cost update.

In a perfect world, cost studies would be updated, hearings would be held, and a decision would be implemented on a timely basis and no intervening updates to cost studies would be necessary. However, although I believe that the Department and many industry participants aspire to move in that direction, this Hearing and the implementation of its outcome is not being done on such a timeframe. Both the CDFA and CPDMP cost studies cover cost periods that primarily resided in 2004 or through the early part of 2005. As a consequence, the cost studies seriously understate the energy cost component. The Decision will not be implemented until some time in 2007 and the next update of the CPDMP cost study has not started. Given the age of the underlying cost data, the significant increase in energy costs subsequent to the study period, and the extended timeframe before a full cost study update is completed, it is absolutely critical that the Department adopt make allowances that reflect the energy cost increases.

Dr. Mark Stephenson provided substantive testimony and an estimated energy cost change by product at the Hearing and the Department should incorporate the energy adjustment in their determination of an appropriate make allowance. [Stephenson, Tr Vol V, pages 38 – 41]

V. The market value-based approach to the return on investment (“ROI”) calculation in the CPDMP study results in an underestimation of plant manufacturing costs.

One area of difference in the methodology between that employed by Dr. Stephenson in the CPDMP study and the CDFA study is the basis of value for the purposes of calculating an ROI. CDFA develops an asset schedule for the enterprise being costed and depreciates those assets based upon useful lives. In contrast, given the limited resources available for the CPDMP study, Dr.

Stephenson established the asset value based upon a market value approach [Exhibit 76, page 5]. This approach involved asking the plants to provide the market value of the plant if sold either as a going entity or in parts.

The market value approach to asset valuation is not appropriate for the determination of asset value for ROI calculation purposes for establishing make allowances. This market-value approach will result in widely varying responses for the same facility depending upon the economic environment under which it is asked. When a plant and industry is struggling financially, the prospects for selling the assets are depressed. Therefore, the current environment of high industry stress due to the overvaluation of milk under the Orders would likely have a negative impact on the expected market value of an asset. Additionally, the capital investment required in an operation generally surpasses its resale market value early in its life cycle.

Ultimately, the ROI must be sufficient to justify the ongoing reinvestment and replacement of assets, and basing the ROI calculation on a criteria as subjective as a plant operator's sense of what the assets could be sold for on that day does not accurately reflect the investment that must earn a return.

Conclusion

The Department's final decision in this preceding is critical to the health of the manufacturing sector of the dairy industry. The manufacturing sector serves a critical role in both converting milk into less perishable marketable dairy products and in balancing the market. Although manufacturers will operate at losses for limited periods in an attempt to cover fixed overhead on sunk investments so long as their variable costs are being covered, the long-term viability of the manufacturers is jeopardized if they operate at a loss over an extended period. The fixed relationship between finished product values and regulated milk price limits the flexibility of manufacturers to adapt to increasing cost structures, and

jeopardizes their viability long term unless the regulated prices are set at levels that either allow increased costs to be absorbed or are updated on a frequent basis. Neither of these is the case at this time. One only needs to read the publicly available financial reports of manufacturing cooperatives to know that the current milk price formulas are resulting in significant losses and erosion of equity. Proprietary cheese makers are experiencing the same hardship. The ultimate result of this situation, if not remedied, is the disorderly marketing that results from reduced plant capacity.

Some have argued that it is inequitable for make allowances to be increased for manufacturers without explicitly addressing similar cost increases on the farm side. This argument ignores the reality that dairy producers receive their compensation from the overall market price levels. Supply and demand factors that operate outside of the regulations will move commodity prices and address the farm level financial pressures. Manufacturers cannot achieve relief through these same supply and demand factors because, under the circularity of the milk price formulas, increased manufactured product values are translated into higher milk prices. Under this system, it is critically important that the Department set the make allowance at levels that allow manufacturers a reasonable return and that the Department be prepared to adjust the make allowances on a timely basis in the future.

The Decision does not establish make allowances that will be adequate to restore or maintain the health of the manufacturing sector. The make allowances appear to have been arrived at by the selective use of data to achieve a specific goal. The Department finds it notable that DFA and Select Milk Producers, cooperatives that both have some ownership in cheese manufacturing assets, have stated that they do not require an increase in make allowances [71 Fed. Reg. 67487]. This naïve reliance on statements from two cooperatives whose investment in cheese assets is minimal relative to their overall milk sales as a

barometer for the need for regulated price relief is dangerous and ignores the Department's fiduciary responsibility to ensure that the regulations it promulgates are based upon sound policy.

The Department's decision must be based upon objective policy analysis in order to create an environment where orderly marketing can occur. The Tentative Final Rule is not based upon the consistent application of objective principles and is not based upon objective policy analysis.

The Department should adopt make allowances based upon the energy cost-updated CPDMP cost studies plus marketing cost at a minimum. Therefore, the make allowance for cheese should be set no lower than 20.77 cents per pound of cheese and the make allowance for dry whey should be set no lower than 20.32 cents per pound of dry whey.