USDA
OALJ/OHC
17 PM 3:44
RECEIVED

UNITED STATES DEPARTMENT OF AGRICULTURE

BEFORE THE SECRETARY OF AGRICULTURE

In re:	)	**Docket Nos.** AO-14-A74, et al.; DA-06-01
Milk in the Northeast and	)	
Other Marketing Areas	)	
	)	

POST-HEARING BRIEF OF THE NATIONAL CHEESE INSTITUTE

This post-hearing brief is submitted with respect to the hearing held January 24-27, 2006, to consider proposed changes to all federal milk marketing orders in the make allowances used in all class price formulas. The brief is submitted on behalf of the National Cheese Institute (NCI), a trade association representing manufacturers, marketers and distributors of cheese and related products. NCI's approximately 70 member companies manufacture and/or market more than 80% of the cheese consumed in the U.S. As buyers and processors of milk, members of NCI have a critical interest in this hearing. Most of the milk bought and handled by NCI members is purchased under the Federal Milk Marketing Orders (FMMOs) promulgated pursuant to the Agricultural Marketing Agreement Act of 1937 (the AMAA).

Based on the record presented at the hearing, NCI strongly urges USDA to change the make allowances used to calculate minimum prices for all classes of milk under FMMO regulation. As testified to by witnesses from NCI as well as others, NCI urges USDA to adopt changes to the make allowances as follows:

1. USDA should update the make allowances used in all FMMO minimum class price formulas using the methodology used to establish the current make allowances, but with the most recently available industry cost data from both the California Department of Food and Agriculture and USDA's Rural Business Cooperative Service. In addition, since the most recent data from these two sources covers industry cost data from 2004, these costs should be updated for the dramatic increases in energy costs between 2004 and 2005 using indices from the U.S. Bureau of Labor Statistics (BLS) for industrial electricity and industrial natural gas.

2. The make allowance for cheese should be set no lower than 18.1 cents per pound.

3. The make allowance for butter should be set no lower than 15.4 cents per pound.

4. The make allowance for nonfat dry milk should be set no lower than 19.7 cents per pound.

5. The make allowance for dry whey should be set no lower than 22.2 cents per pound.

6. The Department should omit a recommended decision and issue and implement a final decision and rule on as expedited a basis as is reasonably possible.

USDA should make these changes based on the following reasons.

1. Numerous witnesses testified to the nature of the price formulas used in FMMOs since January 1, 2000, which result in fixing the margin between the price manufacturers receive for the dairy products they produce and the minimum price they must pay for the milk used to make those products (Yonkers, Wellington, Schad, McBride, Cryan, and McCully). At that time, USDA adopted a system of product price formulas which utilize the price of finished products to determine the minimum milk prices that must be paid to farmers. Since April, 2003, these make allowances have been based on industry cost data from 1997-1999 presented at a May 2000 hearing. Oversimplifying slightly, a product price formula sets the minimum prices that farmers must be paid for their milk as the price handlers receive for their finished products (such as cheese or butter) minus the costs the handlers incur in turning farm milk into those finished products (commonly referred to as the "make allowance").

Therefore, the make allowance is the fixed difference between the wholesale sales value of a manufactured dairy product and the minimum regulated cost to purchase the raw milk necessary for that product's production. This make allowance is used for many economic purposes, e.g., to pay for the use of the capital necessary to build and maintain the plant, to cover the non-milk costs relating to obtaining raw milk, to pay for marketing the processed dairy product, to pay wages to employees of the manufacturing plant, to pay utility companies for the water, electricity and natural gas used to manufacture the dairy product, to buy ingredients other than raw milk, and to cover a wide variety of other expenses such as plant maintenance, equipment, and insurance.

Wellington noted that "Manufacturing allowances that are fixed in the class pricing formulas bear no relationship with the selling prices of any of the dairy products mentioned or the prices received by farmers for their milk. If cheese, butter, nonfat dry milk (NFDM) and whey powder prices were to double tomorrow, Class III and IV prices and farm prices would more than double, but manufacturing plants would receive the exact same allowance. In fact, manufacturing costs for energy, insurance, labor, capital and/or any other input could double yet the manufacturer would not get one penny more to cover those costs under the existing order provisions."

Schad noted that "The manufacturing allowance is fixed; any increases to the selling price to capture increased costs are reported to NASS and all dairy farmers, regardless of whether their marketing organization incurred the costs, benefit fiom the higher class prices."

McCully noted that "Unfortunately, with the adoption of the current make allowances in April 2003, coupled with dramatically higher costs over the last several years, the manufacturing sector has suffered. Prior to 2000, Kraft was concerned the adoption of product formulas to price milk would lead to the very problems we've seen over the past few years. The issue we are discussing at this hearing specifically addresses the inability of manufacturers to cover increased costs through the sale of finished products. If manufacturers attempt to do this, the circularity of the formula results in the milk cost increasing by the same amount, and thus not recouping their higher costs."

Cryan noted that "Federal order milk prices are minimums, so that if the demand for milk is strong enough, the market will produce price premiums above the USDA-set minimum. By contrast, make allowances define a maximum milk-to-cheese margin that the average cheddar cheese maker, for example, can get for his trouble. Since the current formulas define milk prices as a fixed function of the product prices, the milk price rises when the average product price rises. If the fixed margin becomes inadequate to cover costs for the average plant, there is no room for processing premiums. That is, while market forces can correct regulated milk prices that are too low, the make allowance can only be adjusted by USDA. Under current conditions, these make allowances are too low. This undermines the ability of Federal order-regulated plants to operate. This, in turn, undermines Federal orders, which rely on manufacturing plants, including especially cooperative plants and cooperative-supplied plants, to balance overall milk supplies. If those outlets are pushed into state-regulated and unregulated markets, they cannot effectively provide those services, putting all participants in Federally-regulated markets at a disadvantage."

There were no witnesses for companies which manufacture Class III and IV products who did not note the problems created when manufacturing margins are fixed and manufacturing costs beyond their control increase. Wellington, representing a cooperative, in particular noted that the losses created from this problem are borne unequally by producers when those producers are members of a cooperative which owns and operates plants which process Class III and IV products.

2. **Detailed 2004 information from the same sources of industry cost data used to set the current make allowances for cheese, butter and nonfat dry milk clearly demonstrate that costs of manufacturing increased significantly between the 1997-1999 period data used to set the current make allowances and 2004.** Following a May 2000 hearing, USDA used 1997-1999 industry cost data from these two sources to determine the current make allowances for cheese, butter and nonfat dry milk Witnesses from USDA's Rural Business Cooperative Service, or RBCS, (Ling) and the California Department of Food and Agriculture, or CDFA, (Krug and Reed) presented data from the most recent industry cost surveys. . No other witnesses testifying at the January 24-27, 2006 hearing presented any information challenging this updated data provided by RBCS and CDFA. Both RBCS and CDFA witnesses testified to the collection and summarization of the actual 2004 industry cost data presented.

In addition, several witnesses testified regarding their participation in either the RBCS or CDFA collection of this data (Wellington, Schad, Gulden, Weis, McBride, Stroup, Hollon and Taylor). All confirmed the accuracy of the cheese, butter and nonfat dry milk manufacturing cost data submitted for their companies.

Numerous other witnesses testified to increases in specific cost categories their firms have experienced between the period when data was collected to set the current make allowances (1997 - 1999) and 2005 data. Yonkers, McCully and Cryan testified about the general level of energy price increases using data from the U.S. Department of Commerce, Bureau of Labor Statistics (BLS). Others testified about specific cost increases experienced by their company's plants for various cost categories (Langworthy, Carlson, Schad, Weis, Davis, Galarneau, Dryer, DeKruyf, Stroup, and McCully).

3. **Testimony by Langworthy, McBride and Taylor demonstrate RBCS dry whey in-plant costs are both incomplete and not representative of typical U.S. whey drying facilities; therefore, USDA should rely on data in the hearing record regarding the incremental cost of drying whey above the costs to dry nonfat dry milk in updating the dry whey make allowance.** The testimony established the unreliability or the RBCS data regarding the costs of drying whey. McBride testified regarding costs for condensing whey at one plant before transfer to another plant for drying which should have been included in the RBCS cost survey, but which his cooperative failed to include in the cost data they submitted to Ling. In addition, both Langworthy and McBride testified about the costs to transport liquid condensed whey from one plant to another for drying which were intentionally excluded from data they sent to Ling due to the survey instructions provided by Ling. Both testified that the transportation costs for moving condensed liquid whey from one plant to another are necessary costs of manufacturing dry whey. Others noted that it is common industry practice to condense whey at one plant for shipment to another plant for drying (Weis, Schad and Taylor). Taylor noted the differences between the average volumes of dry whey processed in the RBCS surveyed plants versus both the CDFA survey average volume and the volume of whey processed by the average plant in the U.S. Taylor concluded that the plants included in the RBCS survey are more representative of plants which accept condensed liquid whey from other plants for drying, emphasizing the problem noted by Langworthy and McBride created by the failure of the RBCS survey to instruct survey respondents to include the costs to transport that condensed whey between plants.

Burleson presented detailed data from his company regarding the incremental cost to dry whey above the cost to dry nonfat dry milk, and Taylor concurred with his analysis. Numerous others testified in support of this method for determining the dry whey make allowance (Yonkers, Wellington, Schad, McBride and Taylor).

4. **All the hearing witnesses representing companies which own and operate plants which manufacture Class III and IV products specifically requested that USDA act as expeditiously as possible in implementing the requested change in the make allowances.** This included Wellington, Carlson, Scheuerman, Schad, Gulden, Weis, Davis, Galarneau, Alexander, Dryer, McBride, DeKruyf, Stroup, McCully and Taylor.

Carlson noted that "the current situation cries out for prompt resolution. Emergency conditions do exist in the manufacturing segment of our industry. We urge the Secretary to omit a recommended decision and proceed to implement an amended (or interim) order with all due haste."

Schad noted that "The testimony given today highlights the increase in costs incurred by butter, powder, cheese and whey plants since 1998-9, when USDA last set make allowances based on the manufacturing costs of those years. Additionally, the defect in the testimony presented in 2000 further highlights the need for the Department to update the butter and powder make allowances based on the most recent cost surveys because there is a question whether those make allowances are currently in error. We request that the Department issue a rule without a recommended decision."

Scheuerman noted: "I urge USDA to move swiftly and decisively to provide immediate relief to the U.S. cheese processing industry. At current margins, many companies will measure their future in months instead of years. If cheese companies are not permitted to be financially solvent, then the long term outlook for producers will be equally bleak." Davis noted: "I can't stress enough the need to quickly modify these cost structures that ultimately determine the formula pricing in order to allow the innovative folks in this industry to concentrate on producing and marketing our products. We can't possibly be expected to survive and further invest in this energy and labor intensive industry, all the while being economically tied down by cost structures not even remotely connected to reality."

Galarneau noted: "Due to the significant impact these increased costs have inflicted upon our industry, we believe it is imperative that the make allowance are adjusted on an emergency basis in order to provide needed relief as soon as possible. We anticipate our plants will be experiencing maximum powder production and very high levels of butter output during this coming spring flush. MMPA has a major responsibility for balancing the milk supply in the Great Lakes area and the outlook for this spring will likely bring unavoidable losses to the butter and powder operations of our facilities." Alexander noted: "An expedited decision from this hearing is critical to our cooperative owners. As we head into the spring months facing increased milk production and balancing needs, the unrecoverable processing costs that are being discussed at this hearing, will likely worsen."

McBride noted: "NDA supports the adoption of Agri-Mark's proposal on an emergency basis, without a recommended decision, in order to protect the solvency of the manufacturing base that participates in the Federal Order System. The tight world fuel supply/demand situation and other steadily increasing costs have left most industries exposed to higher costs. The "circular" effect of the NASS product price surveys provides little, if any, opportunity to address increased costs through product price adjustments."

5. **Technical Change.** The hearing notice provides as Proposal No. 2 that USDA will "make such changes as may be necessary to make the entire marketing agreements and the orders conform with any amendments thereto that may result from this hearing." Either as a direct result of Proposal No. 1 or as a result of Proposal No. 2, the advance pricing formula for butterfat, Section 1000.50(q)(3), which incorporates the make allowance for butter set forth in Section 1000.50(k)(1), should be change to reflect the make allowance adopted for butter. This could be accomplished either by substituting in Section 1000.50(q)(3) the new make allowance for butter for the old make allowance for butter, or by amending Section 1000.50(q)(3) to incorporate by reference the butterfat price set forth in Section 1000.50(k)(1), in the same fashion as is done with respect to the other advance pricing factors in Section 1000.50(q).

CONCLUSION

The hearing record unequivocally establishes that manufacturing costs have increased significantly since the cost surveys that were used to establish the current make allowances. The current structure of the federal order system requires that the make allowances be adjusted as needed to reflect true costs. USDA should omit a recommended decision and act as expeditiously as reasonably possible to do so. USDA should set per pound make allowances no lower than the following: cheese, 18.1 cents; butter, 15.4 cents; nonfat dry milk, 19.7 cents per pound; and dry whey, 22.2 cents per pound. The Class I advance price formula should be conformed to these new make allowances,

Dr. Robert Yonkers
Chief Economist and Director
of Policy Analysis
International Dairy Foods Association
1250 H Street, N.W.
Suite 900
Washington, D.C. 20005