

UNITED STATES DEPARTMENT OF AGRICULTURE  
AGRICULTURAL MARKETING SERVICE

USDA  
OALJ/HCO

2001 FEB -9 P 1:20

In Re:

Milk In The Northeast and  
Other Marketing Areas

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Docket Nos  
AO-14-A69, et al.;  
DA-00-03

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LEPRINO FOODS COMPANY'S  
COMMENTS ON THE TENTATIVE FINAL DECISION

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These comments are submitted on behalf of Leprino Foods Company ("Leprino") with respect to the Tentative Final Decision ("Tentative Decision") regarding changes in the Class III pricing formula, published at 65 Fed. Reg. 76831 et seq., December 7, 2000. Leprino operates eight mozzarella manufacturing facilities that receive milk regulated by the Federal Milk Marketing Orders ("FMMOs") amended by the Tentative Decision. These facilities are located in Waverly, New York; Allendale and Remus, Michigan; Ravenna, Dodge, and Hartington, Nebraska; Fort Morgan, Colorado; and Roswell, New Mexico. Additionally, Leprino operates plants in Tracy and Lemoore, California that are regulated by the state of California. Our cheese is primarily used as an ingredient by major pizza chains, independent pizza restaurants, as well as by many of the nation's leading food companies in products such as pizza, fresh and frozen entrees, and appetizers.

**I. USDA Should Implement A Final Rule On An Expedited Basis.**

Leprino is vitally interested in the outcome of these proceedings and urges the United States Department of Agriculture ("USDA") to issue and implement a Final Rule on an expedited basis. The time frame for a Final Decision to be issued is more critical due to the issuance of a Preliminary Injunction by the District of Columbia District Court on January 31, 2001, enjoining the implementation of that portion of the Tentative Decision that priced Class III fat at the cheese

value. The implementation of a part of, rather than the entire, Tentative Decision Class III formula is particularly problematic because the component formulas under the FMMOs are used to purchase whole raw milk and must be viewed as an integrated whole. Through the mechanics of this injunction, the Class III price is increased by an estimated \$0.10 to \$0.15 per hundredweight, depending upon the relative market values of cheese and butter. Because this unintended interim price enhancement caused by the District Court's decision is the result of severing a part of the decision without consideration of the impact on the integrated whole, it is critical that the formulas once again be reviewed comprehensively based on the comments received and in the context of the Court's ruling, and that a Final Decision be issued and implemented on a timely basis. As a manufacturer that produces cheese from raw milk, this increase in cost is of significant concern to us and we urge the Department to do everything within its power to complete the rulemaking process quickly so as to minimize the market disruption caused by the District Court's decision.

## **II. The Department Should Not Reopen The Hearing Record.**

The Department should not reopen the Hearing Record to address the deficiencies cited by the District Court in its decision to issue the Preliminary Injunction referenced in Section I above. The entire dairy industry has dedicated significant resources toward the development of a product-price based Class III formula over the last four years, first through the informal rulemaking process in association with Federal Order Reform ("Reform") mandated by the Federal Agriculture Improvement and Reform Act of 1996 ("FAIR Act"), and more recently through the formal rulemaking process mandated by the 2000 Consolidated Appropriations Act ("2000 Act"), which resulted in the Tentative Decision. The Hearing Record is comprehensive and provides an adequate basis upon which to make a decision. Additionally, a reopening of the Hearing Record will further delay the issuance and implementation of a comprehensive Final Decision, prolonging the period during which cheesemakers are subjected to an overall price level that is an arbitrary artifact of a court decision and is not justified by the Hearing Record.

### **III. Summary of Changes to the Tentative Decision**

For the reasons described in these comments, the following changes should be made to the provisions of the milk marketing orders contained in the Tentative Decision:

- A. The dry whey make allowance should be increased to no less than 15.92¢.
- B. The other solids price snubber should be eliminated.
- C. The barrel price adjuster should be reduced from 3¢ to 1¢ if the barrel price used in the formula is stated at 38% moisture.
- D. The butterfat price should be based on the butter value of fat, and the incremental fat value of cheese should be assigned to the protein component.
- E. The butterfat to protein relationship factor of 1.28 in the Class III protein price formula should be reduced to reflect the ratio in average producer milk, which is approximately 1.22.
- F. The yield factors should reflect losses that occur between the farm and plant, and within plants assuming best practices.
- G. The protein yield factor of 1.405 should be reduced.
- H. The cheese yield from fat factor of 1.582 in the Class III protein price equation should not be increased.
- I. The NCI and CDFA cost studies should be used to establish make allowances.
- J. In no case should the Class III price be enhanced relative to the Reform price levels.

**A. Based upon the Record, the dry whey make allowance should be increased to no less than 15.92¢.** As the Department is well aware, Congress required the Secretary to hold a formal, on-the-record rulemaking Hearing on manufacturing allowances and yields used in establishing component prices. (See 2000 Act). As such, the Secretary must base her decision on the Hearing Record. If she fails to do so, the decision is subject to judicial challenge as arbitrary, capricious, not in accordance with law, and violative of due process.

In this matter, the Hearing Record contains evidence demonstrating that it costs more to dry whey than to dry nonfat dry milk and this evidence is incontrovertible and, even more important,

uncontested. C.K. Venkatachalam showed that incremental energy and equipment costs alone comprise an additional \$0.02559 per pound processing costs relative to nonfat dry milk. (Venkatachalam (Leprino) Testimony, Tr. 1386 - 1414). The Kraft witness also noted a \$0.026 per pound higher cost to dry whey than nonfat in their Tulare operation. (Reinke (Kraft) Testimony, Tr. 1041). The National Milk Producers Federation ("NMPF") witness concurred that the lower beginning solids level and additional crystallization process results in a higher cost to produce whey than nonfat dry milk. The NMPF witness proposed that, in the absence of a whey study, the whey make allowance should be set by adding an allowance to reflect these incremental costs for energy and equipment. (Coughlin (NMPF) Testimony, Tr. 190, 198). Applying this methodology to the Tentative Decision nonfat dry milk make allowance of \$0.14 results in a make allowance of \$0.1656 per pound whey. The whey plant study summary prepared by Tillamook Cooperative Creamery (Exhibit 54-5) shows an anticipated cost of \$0.168 per pound at their new Boardman facility assuming maximum utilization. Agrimark testified that they chose to produce specialty products rather than sweet whey at their Middlebury plant because the costs of producing sweet whey are so much higher than the cost of producing nonfat that they did not feel that they could be profitable producing sweet whey (Wellington (Agrimark) Testimony, Tr. 1489). Northwest Dairy Association has come to a similar conclusion in their analysis of whey costs and returns (Marshall (Northwest) Testimony, Tr. 1802).

The NCI whey cost study conducted by Association Services is the only current whey manufacturing cost study available. The Tentative Decision discards the NCI study citing concerns that it was compiled by a company that was not experienced in the industry, using data from cheesemakers who have an interest in the outcome of the hearing, and that participants in the study were not willing to answer questions. These concerns are misplaced. First, the cost studies were compiled by professionals with substantial expertise in the areas of economic and statistical analysis. They thoroughly reviewed the data under the guidance of an agricultural economist with a Ph.D. and substantial industry knowledge. Second, to ensure data integrity and accuracy, the data requested for the study was for the most recent audited period. Additionally, the request and participation was representative of all plants identified as producing the

applicable product in USDA's "Plants Approved" list, whether cooperatively or privately held. (Yonkers (IDFA) Testimony, Tr. 289 - 290; Taylor (Leprino) Testimony, Tr. 1737 - 1738). Third, in response to the contention that witnesses were not willing to respond to questions relative to their participation, Leprino provided cost data for the study on the only two sweet whey plants we operate and referenced our participation in Sue Taylor's prepared statement. The witness was prepared to respond to questions regarding Leprino's specific data, but no questions were asked of the witness. The NCI whey study is sound and should be considered in establishing the make allowances. The NCI whey study shows a cost of \$0.1592 per pound.

There is no testimony in the Hearing Record that supports the Tentative Decision to set the whey make allowance at the same level as the nonfat dry milk make allowance. In fact, as described above, the Hearing Record is replete with evidence supporting a whey make allowance of at least \$0.165. Not surprisingly, therefore, the Secretary cites no authority to support her decision. Rather, she states that somehow the record does not indicate any clear support for a particular differential or total cost level. It is inconceivable (and inconsistent with the law applicable to Federal rulemaking) that the unanimous support for a higher whey make allowance is dismissed presumably because witnesses cite slightly different costs. Rejection on this basis is inconsistent with the establishment of make allowances for other components for which a variety of manufacturing costs exist. It is logical that costs will vary from plant to plant.

All of the evidence in the Hearing Record leads to the inescapable conclusion that the whey make allowance should be set at no lower than the NCI study level of 15.92¢. In fact, nearly all of the evidence received at the Hearing on whey make allowance supports an increase that is greater than the 15.92¢ from the NCI study.

**B. The other solids price snubber should be eliminated.** A consistent methodology must be applied to establishing regulated prices, regardless of market conditions. It is not sound policy to extract only the positive net revenues through a regulated milk price formula. By definition, a snubber that does not allow the negative net revenue of a product to be reflected in the milk

price, such as that incorporated in the Tentative Decision other solids formula, overvalues milk. The implementation of a snubber is contrary to both USDA's conclusion in the Reform process and the premise accepted by nearly all of the Hearing participants that milk used for manufacturing should be priced relative to finished product markets in order to properly reflect supply and demand.

In no case should cheesemakers be held accountable for a greater milk value than is generated in the finished product markets. Whey processing is a necessary aspect of most modern cheesemaking facilities, regardless of returns, due to the environmental risks and cost of disposal of liquid whey. Over the years, market opportunities for whey have developed to a point where the market value of whey generally exceeds the cost of whey processing. However, regardless of the returns available at a given time, cheesemakers must incur the costs of processing the liquid whey byproduct of cheesemaking to reduce environmental risk. If the whey value is not explicitly reflected in the regulated milk price, the net whey revenue from positive periods can offset the net losses from periods when processing costs outstrip the market value of whey. Under the current Class III formulas, however, the positive net revenue is paid out monthly in the form of milk cost, so there is no pool of money generated by the whey processing operation from which to absorb losses when market values fall below the cost of processing. If producers want to participate in the rewards of whey processing by capturing the net revenue in the milk price, they must be willing to also participate in the risks.

The Tentative Decision snubber discussion references a post-hearing brief submitted by MMPA advocating that in no situation should a negative other solids market return be reflected in the milk price. The MMPA brief references a portion of an answer from a DFA witness in which the witness comments that it is difficult to explain why a regulated price is negative. Absent from the brief (and the Tentative Decision) is the DFA witness's elaboration that he prefers that the negative value be shifted in the pooling process to the producer price differential. (Hollon (DFA) Testimony, Tr. 1607).

Communication simplification is not a valid policy justification for economically disadvantaging cheesemakers. If a negative component price is problematic in producer payments, it can be addressed by (1) allowing the Class component price to go negative and pool the negative value to producers as part of the producer price differential as suggested by the DFA witness, or (2) snubbing the Class III other solids price at zero and crediting the negative value to the protein price. In fact, prior to Federal Order Reform, the other solids price was snubbed at zero and the protein price was adjusted for the snubbed negative market value in the Chicago Regional, Nebraska-Western Iowa, Upper Midwest, Eastern South Dakota, and Iowa Marketing Orders.

**C. The barrel price adjuster must be reduced from 3¢ to 1¢ if the barrel price used in the formula is stated at 38% moisture.** The logic espoused in the Tentative Decision justifying continuation of the 3¢ price adjuster is flawed in three ways. First, the regulated pricing structure during sixteen of the 22 months analyzed (73% of the period analyzed) incorporated a cheddar block price adjuster that resulted in distortions in the block - barrel price spread. Second, the analysis errs in substantiating the adjuster by comparing the block price with the 39%, rather than the 38%, moisture-adjusted barrel price. And third, the analysis errs in concluding that, because on an individual monthly basis the block-barrel spread does not adjust lock step with the moisture adjustment as calculated at the respective month's price level, the moisture adjustment is not part of the market-based block-barrel spread.

The period from May 1995 through December 2000 is not valid in analyzing the market-driven block-barrel price differences. This is a period of time that the BFP formula incorporated the product price updater that explicitly referenced cheddar blocks, but not barrels. Statements made by Cooperative leadership at public meetings and documented in the trade press clearly indicated that there was a strategy during that period to enhance producer milk prices by enhancing cheddar block prices. Since cheddar barrels were not explicitly in the milk price formula, the barrel price did not benefit from the same price enhancement activity. In fact, barrel prices quite likely suffered from displacement as blocks not needed for cut and wrap operations replaced barrel cheese in processed cheesemaking. While these kinds of artificial distortions that do not

reflect market fundamentals are ultimately addressed by the marketplace through infrastructure adjustments, a prolonged period of time is often required before the necessary capital investment can be justified. These infrastructure adjustments, in the form of adding block making capability to some barrel plants, did not occur until mid to late 1999. Therefore, the entire period from May 1995 through December 1999 should be considered irrelevant for the purposes of analyzing market-driven block-barrel spreads.

The only period for which NASS cheddar price data exists that is not tainted by the regulated price formula incentive to enhance block, but not barrel, prices is calendar 2000. Class III protein prices during 2000 were calculated using both cheddar blocks and barrels. During calendar 2000, the average spread between the block price and a 38% moisture adjusted barrel price was 1.54¢. To assess the spread over a longer market period, the National Cheese Exchange prices can be analyzed. During the five years immediately preceding the implementation of the BFP updater (May 1990 - April 1994), the average difference between the cheddar block price and the 39% adjusted barrel price was 3.08 ¢, and the difference between the cheddar block price and the 38% adjusted barrel price on the CME was 1.05¢.

The Tentative Decision postulates that the block-barrel spread should move lock-step with the moisture adjuster at various price levels if the moisture adjuster is a contributing factor in the spread. Because the spread does not move in lock-step, the notion that the moisture adjustment contributes to the block-barrel spread is discarded. This conclusion is wrong because many factors impact the block-barrel spread over short periods. For example, the peak demand season for barrels is in the Spring and early Summer as processed cheesemakers build inventory for the burger season, whereas the peak demand season for blocks is the late Summer and Fall as cut and wrap operators gear up for the high holiday demand season. Therefore, block-barrel spreads generally are compressed in the Spring and expanded in the Fall. Capacity to fully shift production to the more profitable form on an instant's notice does not exist in the industry. As already noted, the flexibility in infrastructure so that some plants can move between the two forms of cheddar was largely not deployed until late 1999. However, this new infrastructure is



not sufficient to fully shift production between blocks and barrels on a short term basis. Therefore, current market forces will continue to drive month to month spreads.

**D. The butterfat price should be based on the butter value of fat, and the incremental fat value of cheese should be assigned to the protein component.** The Tentative Decision substantially changed the conceptual framework under which fat has been priced historically. That is, the Tentative Decision priced fat at the cheese value, rather than at the butter value. The D.C. District Court recently enjoined this aspect of the Tentative Decision from being implemented based on procedural issues. We agree with the Court that the proposal was not properly noticed, and that further consideration was precluded by the Administrative Law Judge ruling at the Hearing. Therefore, we did not address this conceptual approach in our post-hearing brief. However, given USDA's attempted adoption of such an approach in the Tentative Decision, the following portions of this section highlight our concerns with this approach.

Valuing components directly based on the individual component's contribution to the finished product value has some appeal conceptually in isolation of other market considerations uniquely related to classified pricing. The general approach would result in a significantly closer alignment between component values and finished commodity values and distortions created by redistributing value between components would be eliminated. However, the approach has several problems in the context of a regulated pricing system that impedes the convergence of prices across the manufacturing complex through the maintenance of split manufacturing Classes. Pricing fat differently in the two manufacturing Classes provides incentives to shift between fresh and storable ingredients. Additionally, the price signals directed toward producers are inappropriate.

The existence of multiple manufacturing Classes of milk in combination with the ability of some Class III users to functionally use storable forms of fat to displace fresh forms increases the probability that substantial product substitution will occur. The displacement will result in a reduction in producer revenues as least cost component sources are mixed and matched.

Additionally, the displacement will result in market disruptions as those who can substitute shift between fresh and storable fat on a monthly basis, depending upon the net economics.

Also of great importance, the producer payment provisions of the Tentative Decision that were made to accommodate the split fat pricing have the effect of shifting producer incentives away from producing components and toward producing volume. This producer signal is of great concern in a market which increasingly relies on growth in manufactured product demand to absorb increasing milk supplies. The value of milk used to produce these manufactured products clearly is driven by the components, not the water, in the milk. This is the core premise behind moving toward component pricing.

There is also a troublesome redirection of the producer price signal from protein to fat. While one could argue that this is appropriate given current supply and demand balances, we do not believe that this is appropriate long term. The current perception that we have a surplus of protein is an artifact of a price support program that is pricing nonfat dry milk above its supply-demand driven market value. However, in a more global sense, protein is in short supply. Farm level production economics result in producers requiring a much higher price incentive to increase protein production than to increase fat production. Over the long term, protein will remain in short supply and price signals should be provided to producers to increase protein production.

**E. The butterfat to protein relationship factor of 1.28 in the Class III protein price formula should be reduced to reflect the ratio in average producer milk, which is approximately 1.22.** Dr. Barbano articulated a concern that under the Reform Class III formula with a constant cheddar price, as butter prices increase, the protein price decreases at a faster rate than the fat price increases. (Barbano Testimony, Tr. 519). This concern can be addressed by correcting the 1.28 fat to protein ratio in the current formula to be representative of average producer milk composition.

The logic that led to adoption of the 1.28 factor in the Federal Order Reform process (that is, looking at the pounds of fat that can be associated with a pound of protein) is faulty. While we have not confirmed that the 1.28 factor is correct even if that logic is followed, it is clearly inappropriate to incorporate a factor in the raw milk pricing system that inherently reflects a component ratio inconsistent with raw milk. The 1.28 factor infers that cheddar makers must purchase cream routinely to achieve the proper fat to protein ratio. The use of a factor that exceeds the raw milk ratio transfers the incremental value that is derived from the purchase of additional fat into the raw milk price.

A review of FMMO data from 2000 for those Orders with component pricing indicates that a more appropriate factor is 1.22. USDA should therefore replace the 1.28 factor in the protein price equation with 1.22.

**F. The yield factors should reflect losses that occur between the farm and plant, and within plants assuming best practices.** The VanSlyke theoretical cheddar yield formula, upon which the current yield factors in the Class III protein price formula are based, estimates the quantity of cheese produced from components present in a cheese vat. Dr. Barbano recognized that the formula itself does not allow for losses prior to the cheese vat. (Barbano (Cornell) Testimony, Tr. 598). Dr. Barbano advocated reflecting the losses as a cost factor in the make allowance. (Barbano (Cornell) Tr. 595 - 597).

The Hearing evidence that unavoidable component losses occur between the farm and plant receiving, and within plants is uncontested. Component losses between farms and plants occurring in proportion to general volume losses were cited to range from 0.15% in regions dominated by large dairies to over 0.25% in regions dominated by small dairies (Taylor (Leprino) Testimony, Tr. 1728), with some processors experiencing losses up to 0.33% (Reinke (Kraft) Testimony, Tr. 1056). The general industry expectation is that these losses remain within 0.25% (Hollon (DFA, Tr. 1563). Additionally, since fat has a propensity to cling to surfaces, differences between farm tests and plant fat tests average 0.015. (Taylor (Leprino) Testimony, Tr.

1728). Additionally, significant component losses are unavoidable within plants, related to transmission between vessels, as well as necessary cleaning protocols. These losses occur during receiving, pasteurization and separation, in piping, and other vessels throughout the cheese production and finishing process, and throughout the whey and whey cream recovery and finishing process. (Barbano (Cornell) Testimony, Tr. 651 - 654, 707 - 710, 749 - 750). Expert testimony based on a study of effluent leaving 51 cheese plants showed an average cheese plant loses 2.35% of the plant's BOD intake. This 2.35% loss present in the effluent understates the overall milk component loss in the plant because it does not account for high BOD waste streams that are diverted to animal feed, land application or other disposal methods rather than being discharged to the wastewater treatment systems. (Lenahan (Ecolab) Testimony, Tr. 1251 - 1256).

The Tentative Decision proffers that these pre-production losses are addressed through the shrinkage provisions of the Orders and that the within-production losses are reflected in the manufacturing cost studies. Both of these postulates are incorrect. In fact, shrinkage provisions only apply to pool plants, and manufacturing plants are generally precluded from being pool plants by performance requirements under the Orders. To the extent that manufacturing plants do enjoy pool plant status, the shrinkage provisions result in a limited portion of the losses being reclassified to the lowest valued use, resulting in minimal price relief at best. The additional premise that there is an inherent allowance for losses in the cost studies is also clearly erroneous. Cost studies reflect operating costs for the finished products produced, but do not factor in the cost of milk that is paid for but is not ultimately manufactured into finished, marketable products.

**G. The protein yield factor of 1.405 should be reduced.** The 1.405 yield factor assumes that true protein contains 83.3% casein. This assumption is higher than the casein composition of true protein in the general milk supply, which contains 82.2% to 82.4% casein. (Barbano (Cornell) Testimony, Tr. 525). The theoretical vat cheese yield per pound protein calculated by the VanSlyke cheddar yield formula assuming 82.3% casein in 2.99 pounds true protein per cwt milk is 1.388 rather than the 1.405 that exists in the current formula. With typical farm to plant losses of 0.25%, the factor drops to 1.385 per pound of producer protein. Reducing the vat

protein by half of the plant loss of 2.35% results in a yield of 1.367 per pound of producer protein. This is far less than the 1.405 incorporated in the Tentative Decision and still does not fully account for losses within the system.

**H. The cheese yield from fat factor of 1.582 in the Class III protein price equation should not be increased.** The 1.582 yield factor assumes that 90% of the fat present in the vat is retained in cheddar cheese. The 90% factor in the current formula reflects the many cheese vats still in use that were installed prior to the late 1980s and implicitly accounts for some of the farm to plant and within plant losses noted above for those more modern plants that can achieve slightly higher retentions. However, the Class III fat formula overvalues fat that is sold at a discount in the form of whey cream. Any increase in the 1.582 factor would exacerbate the overvaluation of whey fat in the current formula. (Taylor (Leprino) Testimony, Tr. 1761). (Reinke (Kraft) Testimony, Tr. 1041, 1055-1057).

**I. The NCI and CDFA cost studies should be used to establish the cheese make allowance.** As was noted in the whey discussion (Section III(A) above), the NCI cost study conducted by Association Services is a well-constructed and well-executed cost study that should be considered in combination with the CDFA studies for the purposes of the establishment of Class III make allowances under this proceeding. The NCI cheese study complements the CDFA study by capturing data from the geographic area outside California. The cost study was compiled by professionals with substantial expertise in the areas of economic and statistical analysis. They thoroughly reviewed the data under the guidance of an agricultural economist with a Ph.D. and substantial industry knowledge. To ensure data integrity and accuracy, the data requested for the study was for the most recent audited period. Additionally, the NCI survey was mailed to all cheddar plants identified on the USDA plant lists, regardless of ownership form, outside of California to capture the broadest possible population without being redundant with the CDFA cost study. (Yonkers (IDFA) Testimony, Tr. 289).

The NCI survey is more comprehensive in identifying costs associated with converting raw milk

into marketed finished products than the Rural Business Cooperative Service ("RBCS") study. Although there was an attempt in the Tentative Decision to address the deficiencies of the RBCS study by adding a factor for excluded costs, such an approach is clearly less accurate than referencing a comprehensive survey, such as the NCI survey.

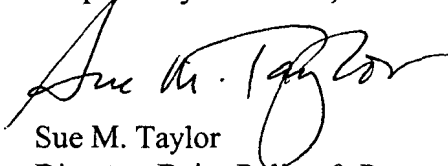
**J. In no case should the Class III price be enhanced relative to the Reform price levels.**

The potential for the minimum regulated price to generate disorderly marketing is increased under end product price formulas, due to their rigidity. Since finished product prices are directly captured in the milk price, any adjustments made to the sales price to adjust for competitive or cost issues unrelated to milk will be reflected in the milk price. The rigid constraints of end-product price formulas based on yields that are too high or make allowances that are too low will dramatically impact the investment, and therefore the plant capacity, of the industry. Therefore, if a regulated price is established by an end-product price formula, it is important to set that regulated price at a level that allows other market forces to work and adjustments to occur outside of the regulated system. (Yonkers (IDFA) Testimony, Tr. 254 - 278; Taylor (Leprino) Testimony, Tr. 1718 - 1720).

**Conclusion**

For the reasons cited above, which are based wholly upon and substantiated by evidence in the Hearing Record, the Department should adopt these suggested changes to the Class III component prices.

Respectfully submitted,



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