



**BEFORE THE UNITED STATES DEPARTMENT
OF AGRICULTURE
AGRICULTURAL MARKETING SERVICE**

**In the Matter of Milk in California;
Notice of Hearing on a Proposal to
Establish a Federal Milk Marketing
Order**

**7 CFR Part 1051
Docket No.: AO-15-0071;
AMS-DA-14-0095**

Clovis, California, September 22, 2015

Testimony of Dennis Schad

**In Support of Proposal 1 of California Dairies, Inc.,
Dairy Farmers of America, Inc., and Land O'Lakes, Inc.**

**Proposal to Establish a Federal Milk Marketing Order for the
State of California**

Cooperatives' Exhibit 6

INTRODUCTION

My name is Dennis Schad. I am employed by Land O'Lakes, Inc. as Director of Middle Atlantic Milk Sourcing and Regulatory Affairs. My business address is 405 Park Road, Carlisle, PA 17015. My present duties at Land O'Lakes are to manage LOL's milk marketing in the Northeast, forecast and budget milk into LOL's butter and powder plant in Carlisle PA and represent LOL at various state and Federal regulatory hearings. I have been employed in the dairy industry since 1981 and have had regulatory responsibilities since 1990. I have testified at federal and state milk pricing and regulatory hearings on several dozen occasions. My testimony today is in support of Proposal Number 1 sponsored by California Dairies, Inc., Dairy Farmers of America, Inc. and Land O'Lakes, Inc.

My testimony concerns the topics of product classification; class prices; prices and price formulas for all classes of utilization; and price announcements. These subjects are addressed in proposed sections 1051.40, 1051.42, 1051.43, 1051.44, 1051.50, 1051.51, ~~and 1051.52~~, **1051.53 and 1051.54.**

We propose that the California federal order adopt the uniform federal order system of product classification and pricing. The product classifications of the CDFA and federal system are very similar; and adoption of the national, uniform federal classifications will involve few changes for California handlers. The federal order system has in place a national pricing grid for all classifications of use; and the prices already explicitly provide for either California-specific prices or prices which are expressly national in scope and have been adopted using California plant costs, and each month's product sales prices from California milk manufacturing plants are reflected. The federal price grids will make the California federal order an integrated part of the national dairy marketplace.

I. The California Order Should Adopt the Uniform System of Classification of Milk and Milk Products.

This Proposal recommends that the Secretary adopt the classified pricing provisions of Sections 1000.40 through 1000.45 and the Fluid Milk and Fluid Cream definitions of Sections 1000.15 and 1000.16. As a general statement of purpose, the Preliminary Report of the Federal Order Reform Classification Committee (November 12, 1996) stated:

In conformance with the Agricultural Marketing Act of 1937, all milk should be classified “in accordance with the form in which or the purpose for which it is used.” Although the primary factors for classifying milk should be its use and ~~from~~^{form}, others factors such as product labeling and equity among competing handlers should also be considered. (Page 2)

In 1974 a uniform Federal order classification plan for 39 markets was adopted and continued through the Federal Order Reform process where uniform classifications of dairy products were adopted for all Federal orders. Since Federal Order Reform, AMS has called two national hearings to consider changes in definitions and classification of milk products. In 2004 AMS called a hearing to address the reclassification of evaporated or sweetened condensed milk in consumer type packages from Class III to Class IV. And in 2005 USDA held a hearing to reconsider the classification of Class I milk.

Referenced in the Federal Order Class I and Class II definitions are Section 1000.15 Fluid Milk Product and Section 1000.16 Fluid Cream Product. Section 1000.16 was unchanged during the Federal Order Reform process and includes “the mixture of cream and milk or skim milk containing 9 percent or more butterfat. . .” This definition would include the consumer product commonly known as half and half.

The Fluid Milk Products section was modified on January 1, 2011 as a result of Federal order hearings held during June 2005. The Final Decision held, “This final decision maintains

the current fluid milk product definition's compositional standard of 6.5 percent nonfat milk solids and incorporates an equivalent 2.25 percent true milk protein criterion for determining whether a product meets the compositional standard.” (75 Fed. Reg. at 33534 (2010))

The California Food and Agriculture Code contains a classified pricing system, which is comparable to the Federal order definitions.

The California Class 1 definition is similar to the Federal Order Class I, with limited exceptions. CDFA defines half and half as a Class 1 product while AMS classifies the product as Class II.

The California Class 2 and 3 definitions are comparable to the Federal order Class II, with notable exceptions. CDFA classifies buttermilk, used in a beverage as Class 2, while the Federal orders assign that product to Class I.

The California Class 4a and 4b definitions are essentially identical to Federal orders Class III and IV.

Exhibit 29 and the testimony of Mr. Nierman were provided by AMS and list individual dairy products, as classified by CDFA, and their corresponding Federal Order classifications. Exhibit 62 and the testimony of Mr. Shippelhoute from CDFA further explained the CDFA classifications.

This Proposal recommends that the California order adopt Sections 1000.15, 16 and 40 in order to effectuate uniform classifications of the forms and uses of milk throughout the Federal orders.

Section 1051.42 refers to the Classification of Transfers and Diversions in part 1000.42. The provisions and the rationale of this section were the subject of testimony by an AMS

witness, Mr. Schaefer, at the start of the hearing. The Cooperatives recommend the adoption of this provision.

Sections ^{and 1000.44} 1000.43 and Section 1051.43 ^{and 1051.44, define the General Classification Rules including} refer to the Classification of Shrinkage, Overage and Producer milk under the Order. The provisions and the rationale of this section were the subject of testimony by an AMS witness, Mr. Mykrantz, at the start of the hearing. The Cooperatives recommend the adoption of these provisions.

II. The California Federal Order Should Adopt For Section 1051.50 the Uniform National Provisions for Class Prices, Component Prices, and Advanced Pricing Factors in 7 CFR § 1000.50.

The Cooperatives propose that the California Federal Order adopt the class price formulae listed in 7 CFR § 1000.50, the text of which is found at Cooperatives' Exhibit 6.A (4 pages.) This section describes the formulae used to develop Class I, II, III and IV prices, the sources of commodity prices used in the pricing formulae and the make allowances and product yields used in the calculation. Section 1000.50 also describes the procedure for setting advanced Class I skim and butterfat prices and advanced Class II solids-not-fat prices. In 2014, AMS reported 129.4 billion pounds of producer milk pooled on Federal orders, while the National Agricultural Statistics Service (NASS) estimated that total U.S. milk production was 200.6 billion pounds, of which 42.3 billion pounds were produced in California. Thus, 65 percent of total national production and 82 percent of national production, less California, was priced by the uniform pricing formulae of the Federal Order system.

California dairy products, like dairy products produced under Federal order pricing, compete for sales in the national market. The Secretary has long recognized that national competition for dairy products sales required prices for milk used to produce these products to be uniform across the Federal orders. While the current price formulae were developed through the

Federal Order Reform process and amended as a result of several national hearings, the formulas' antecedents flow from the Federal orders' precedents of uniform pricing of milk used to produce manufactured dairy products. The established approach of uniform national pricing for milk used to produce dairy products, other than fluid milk, results from a recognition that these products compete in a national marketplace. Pricing California milk production under the national class price grid is essential to extend uniform pricing to a fifth of the nation's milk production.

A. The Evolution of a National Manufacturing Price.

The evolution from regional class prices to a national class pricing grid can be traced to the adoption of the Minnesota-Wisconsin (M-W) price series as the uniform price for milk used to produce manufactured dairy products and the base price for regional Class I prices in all Federal orders. The Minnesota-Wisconsin manufacturing grade milk price series (M-W) was first adopted in 1961 and adopted in all, or nearly all, Federal Orders in the late 1960s. In the 1995 Final Decision of the Basic Formula Price Hearing, the Secretary cited the national character of the M-W price.

The M-W price is a competitive price that represents an estimate of the average of prices paid for Grade B milk in Minnesota and Wisconsin by plants that manufacture butter, nonfat dry milk, and cheese. These products are sold in a national market in competition with such products made from Grade A milk that is in excess of fluid milk needs. Month-to-month changes in the M-W price reflect changes in overall supply and demand conditions for milk and its products nationally. (60 Fed. Reg. 7290, 7292 (1995))

Further in the 1995 Decision, the Secretary describes the mechanics of the M-W competitive price series:

The use of the competitive pay price method of pricing milk is based upon the premise that in a highly competitive economy dairy concerns will tend to purchase milk at prices commensurate with

the more efficient concerns' ability to pay for the product. As shifts occur in the relationship between finished products prices, one group of processors may be able to pay higher prices. The other processors must meet or approximate these prices or lose their supplies. If a dairy concern fails to make the necessary adjustments, it will in time be forced out of business. Increasing labor and other costs will tend to reduce prices paid for milk. On the other hand, the use of new assembling, processing, packaging and marketing techniques which reduce costs or increase product returns will tend to increase prices paid for milk. These upward or downward adjustments in costs would be automatically reflected in reserve prices by using the competitive pay prices method of pricing. (60 Fed. Reg. at 7299 (1995))

It was observed that in the M-W milk pricing environment, milk processors of manufactured products would freely compete for milk in a marketplace of many sellers and buyers. It was assumed in that environment that processors determined the price they could afford to pay for milk based on the sales price of their manufactured product, less the cost of processing. Within that accounting for a cheese manufacturer, if whey was a product that it could sell, it would be a positive value in its ability to pay dairy farmers. However, if whey from the processing of cheese had no value and had to be disposed of, then whey would be a cost. Thus, implicitly, the value or cost of whey was always included in the M-W price prior to Federal Order Reform.

The M-W was a competitive pay price obtained from a survey of manufacturing plants in Minnesota and Wisconsin making payments to producers of Grade B (manufacturing grade) milk. This base month M-W was updated by a survey of a smaller number of plants' pay prices for the succeeding month. At the time the M-W was developed, approximately 50 percent of the total U.S. Grade B milk was produced in those two states. In this context, manufacturing milk included all uses of milk that did not require Grade A, including butter/powder and all forms and varieties of cheese.

As the number of Grade B producers and the number of plants that accepted Grade B milk declined, a change to the M-W was required. The Basic Formula Price (BFP) was established in 1989 as a commodity price updater to the M-W competitive price survey. The products surveyed in the updater formulae were butter, non-fat dry milk, cheddar cheese, and whey powder. The process to determine the Basic Formula Price was described in the 1990 Carolina Order Promulgation decision:

It (BFP) would be computed by increasing or decreasing the M-W price of the second preceding month by an amount that reflects changes in the value of the gross value of milk used to produce cheddar cheese (including whey fat and whey solids non-fat), butter, non-fat dry milk and edible whey powder of the first fifteen days of the preceding month compared to the first fifteen days during the second preceding month. The gross value of milk used to produce these products would be determined by multiplying the price of each product by a yield factor which represents the pounds of product that results from the manufacture of a hundredweight of milk. The yield factors used in the formula adopted herein would be those that are used under the Dairy Price Support Program for determining similar gross values. (55 Fed. Reg. 25618, 25641 (1990))

Although the 1985 Farm Bill changed the calculation of the cheese support price by deleting whey from the formula, nevertheless the Secretary continued to use whey values, make allowances, and yields to compute the BFP. Within the Secretary's decision to report an equivalent price, he wrote:

It is therefore ordered that a whey processing cost of 12.5 cents per pound and a yield factor of 5.5 pounds continue to be used as equivalent factors determining any positive whey value in computing the basic Class III formula price under the above named orders, effective upon issuance of this determination. (55 Fed. Reg. at 25642) (1990)

However, the calculation that determined the BFP prior to FMMO Reform was changed in 1995. The 1995 Basic Formula Price Final Decision redefined the calculation, deleting the whey factor, but, for the first time, including a dry buttermilk factor. The Secretary wrote:

After reviewing the various formulas, it is concluded the best updater would include the following products and representative price series: Grade AA butter, Chicago Mercantile Exchange (AAB); nonfat dry milk, Central States production area (NFDM); dry buttermilk, Central States production area (DBM); Cheddar cheese, 40-pound block, National Cheese Exchange (NCE); and Grade A butter, Chicago Mercantile Exchange (AB). Dry whey is not included in the formula because not all cheese manufacturers process whey, and the disposal of it is a cost to many manufacturers. Furthermore, dry whey is no longer included in calculating the cheese purchase price under the dairy price support program. (60 Fed. Reg. at 7301) (1995)

While the politics of the 1985 Farm Bill ultimately changed the calculation of the BFP by deleting whey from the formula, nevertheless the value of whey continued to be implicitly included in the base BFP through the base month M-W price. Consequently, since 1961 the value of whey has always been included in the national Federal order price for manufacturing milk.

Prior to Federal Order Reform several Federal orders were amended to include multiple component pricing (MCP). These order hearings were held on an individual marketing area basis and subject to decision-making based on hearing evidence. For instance, Order 30 provided for a Protein Price, calculated by multiplying 1.32 times the average monthly 40 pound block cheddar cheese price, as reported by the National Cheese Exchange. The pre-reform “other solids” price for FMMO 30 was calculated by subtracting the butterfat and protein values from the announced BFP Price and dividing by the market’s other solids percentage. While other Federal orders that had MCP pricing utilized a different formula to determine the order’s

protein price, the Class III price, which was the starting point for all orders, was the national BFP. Thus, at standard test, the national Class III price in all orders was the BFP.

B. Exceptions to Price Uniformity in Prices for Milk Used in Manufacturing: Class III-A

The price for milk used to produce non-fat dry milk, Class III-A, was established in November, 1992 in three Federal orders: FMMOs 1, 4, and 124. In the October 20, 1993, Class III-A Decision the Secretary noted that the new Class III-A classification affected only milk used to produce NFDM (not butter) and reiterated his support for national pricing for cheese and butterfat. The 1993 Decision expanded Class III-A pricing from the three original orders, Orders 1, 4 and 124, to an additional 26 Federal orders. [Docket AO-14-A65-RO2, etc.; DA-91-013] The Secretary noted that establishing Class III-A pricing in a limited number of markets caused price misalignments in adjacent markets. 58 Fed. Reg. 58112, 58114-15 (1993)) The formula make allowances that were used to determine the Class III-A were the make allowances legislated in the Commodity Credit Corporation's Dairy Price Support program.

The 1993 Decision reiterated the earlier 3-market decision by continuing the western orders' use of the average Dairy Market News Western Powder Price for orders west of the Rocky Mountains (FMMO 124, 131 and 135) and the average Dairy Market News Central States Powder Price for the other affected markets. The recommended decision proposed to use the Western Powder Price in all orders for the formula commodity price, however the Secretary reversed himself and wrote:

There is obviously some location value associated with NFDM as there is with other finished manufactured products like cheese and butter. However, manufacturers of these finished products compete with each other for sales throughout the nation. Thus currently, the minimum price used for these products is uniform throughout the country, with some minor exceptions. This insures that all processors of these products have the same starting point in

terms of the minimum price for milk. They are then left to compete for sales with each other for sales throughout the country. In some areas the processors would have a location advantage over competitors and in some areas a disadvantage. However, the marketplace and not differences in the minimum price for milk would determine the relative advantages in order to allow competitive forces to continue to operate. The recommended decision concluded that the Class III-A price should be uniform among the Federal order markets as is currently the case with the Class III price. Using different powder prices in the Class III-A formulas could result in substantial price differences among nearby manufacturing plants, depending upon where the dividing line is established for using different prices the recommended decision concluded. Establishing different price levels would not be consistent with the price support program and the national market nature of the NFDM market, the recommended decision further concluded. (58 Fed. Reg. at 58124) (1993)

The Secretary went on to note that the Western price was lower than the Central NFDM prices, but not always at the same magnitude. When NFDM prices were high, the difference would be greater and when the NFDM price was lower, the difference between the price series narrowed. Between September 1991 and August 1992 the difference between the price series ranged from 2.4 cents per pound to 6.2 cents per pound and averaged 4 cents for the period.

Noting that about 60 percent of NFDM was manufactured in the Western Region, the Secretary opted to maintain the regional price factor in the Class III-A price formula. In doing so, the Secretary rejected a suggestion that the formula use the Central States price and discount that price for the Western orders by a fixed amount to represent transportation. He noted that the difference in prices between the price series fluctuated. (Id. at 58124-125) (1993)

Of the 31 Federal orders included in the 1999 Annual Summary, 21 orders had provisions for Class III-A pricing. Due to the Seasonal Adjusters of the three Northeastern orders, and two separate price series (Central States and Western States), there were five different monthly prices for the 23 orders. However, the variation of the 1999 average Class III-A prices was slight:

Order 1, \$12.14; Order 2, \$12.22, Order 4, \$12.16; Western Area, (Pacific Northwest, Central Arizona and the Southwestern Idaho and Eastern Oregon) \$12.04 and Other Areas, including Carolina, Southeast, Michigan Upper Peninsula, Southern Michigan, Eastern Ohio-Western Pennsylvania, Ohio Valley, Indiana, Chicago Regional, Louisville-Lexington-Evansville, Upper Midwest, Iowa, Nebraska-Western Iowa, Southwestern Plains and New Mexico-West Texas, \$12.14. There was a \$0.18/cwt range of 1999 average Class III-A prices between the New York-New Jersey order and the lowest prices in the Western area. (1999 Federal Milk Marketing Order Statistics, Annual Summary, Table 30)

It is important to note that in 1993, a sales-weighted national average NFDM price was not available. The Secretary had to rely on a voluntary and unaudited survey of un-~~weighed~~^{weighted} weekly sales of NFDM reported in the Dairy Market News. Had the Secretary had access to a national weighted average NFDM price that would have been influenced by the western region's 60% of nation's production, as the NASS price is, he may have come to a different conclusion on the establishment of regional Class III-A prices. Nevertheless, when you allow for the Season Adjusters in the three Northeast orders that would have been present even without Class III-A pricing, the average Class III-A difference was \$0.10 per cwt. The informal rule making process of Federal Order Reform allowed AMS to better standardize and make uniform the prices for milk used to produce Class II, III and IV products. As a result of Federal Order Reform, since 2000 no Federal order contains a seasonal pricing provision, nor does any Federal order include regional pricing factors for milk used in manufacturing.

C. Uniformity of Prices for Class II

As a result of a national hearing held in 1991, the Class II price was established in all Federal Orders as the Class III price plus \$0.30 per cwt. At the time of Federal Order Reform,

all Federal orders, except the New York – New Jersey order charged the same price for milk used to produce Class II products. Only Order 2, which included farm point pricing, maintained a location adjuster on Class II volumes. On average the Order 2 price was \$0.08 higher than other Federal orders.

D. Uniformity of Class III Prices Pre-Order Reform

In 1999, all orders except the three Northeastern orders charged the same Class III price. The average Class III price for milk pooled on Order 2 was \$0.09 higher than the national average price; Order 4, \$0.03 higher and Order 1, \$.01 greater. (Federal Order Market Statistics, 1999 Annual Summary, Table 30) These deviations from the national price for milk used to produce Class III products were the result of each order’s Seasonal Adjuster. The Final Decision of Federal Reform noted that these adjusters had been a factor in the orders’ milk pricing for 30 years, and predated the national adoption of the M-W price series in all orders. (64 Fed. Reg. 16026, 16149 (1999))

While Seasonal Adjusters were “grandfathered” into the Northeast orders, the Secretary declined an opportunity to extend the provision to other orders. A Seasonal Adjuster was proposed for the hearing held to consolidate the Georgia, Alabama-West Florida, New Orleans-Mississippi, Greater Louisiana, Paducah, Kentucky and Central Arkansas orders during 1993-1994. The Secretary rejected the proposal, citing that the Class III-A price provided adequate relief for the proponents’ claimed balancing costs. (60 Fed. Reg. 25014, 25036 (1995))

III. Federal Order Reform Results in Uniform National Pricing of Milk Used to Produce Class II, III and IV Products.

A. A New Uniform Set of National Class Prices

As noted earlier, the quest for milk price uniformity was ongoing at the Department. For instance, at the 1989 Carolina order promulgation hearing, a proposal was made by three

handlers to continue the butterfat pricing factor contained in both the North and South Carolina State orders and to establish for the new Federal order a butterfat differential formula of .1 times the Chicago Grade A butter price. At the time, the butterfat formula in the adjoining Federal orders and all Federal orders was .115 times the Chicago butter price. Testimony was provided at the Hearing that the difference between the formulas would affect producers' pay price (not the butterfat price) by only \$0.04 to \$0.06/cwt. Citing the difference between the States' orders and the Federal orders' butterfat pricing as a factor in disorderly marketing, the Secretary ruled against the proposal. The Secretary said, "if such a modification were adopted the value of butterfat and skim milk in the Carolina market would not be aligned with such values under the neighboring Federal order markets." (55 Fed. Reg. at 25623, 25643) (1990)

Section 143 of the 1996 Farm Bill directed that the Secretary consolidate the (then) 31 Federal orders to a number of between 10 and 14. Further, the Secretary was authorized to address related issues such as the use of utilization rates and multiple basing points for the pricing of fluid milk and the use of uniform multiple component pricing when developing one or more basic formula prices for manufacturing milk. The Conference Committee Report of the 1996 Farm Bill instructed the Secretary, "There is no limitation to the number of issues the Secretary may consider when consolidating the orders." (Conference Report to accompany H.R., 2854, March 25, 1996, pg. 338)

In addition the Secretary was instructed to effectuate the reforms to Federal orders by utilizing the informal rulemaking procedure. While formal rulemaking required AMS decision making to be limited to the evidence on proposals provided by interested parties at a formal hearing, informal rule making permitted AMS more latitude to develop its own proposals, based on industry comments, and evidence. AMS established five committees composed of AMS and

market administrator staff. Those committees were Price Structure, Basic Formula Price, Identical Provisions, Classifications and a Regional Committee, composed of Mideast, Northeast, Southeast and Western regions. In addition to utilizing USDA personnel, partnerships were established with two university consortia to provide expert analysis on issues relating to price structure and basic formula price options.

The broad authorization and informal rulemaking procedures granted in the ¹⁹⁹⁶~~1995~~ Farm Bill allowed AMS to standardize milk classifications, pricing and procedures into a national system.

In the Recommended Decision of Federal Order Reform the Secretary wrote:

The new basic formula price should be simple to derive and easy for the dairy industry to understand, since it would be used in all Federal milk orders. The BFP also should be transparent. That is, it should be possible to see and understand the derivation of the BFP, even if a complex formula is used to determine the price. Further, the new basic formula price should be applied uniformly within orders and on a national basis.

The most important criterion is sound economics--the ability of the BFP to reflect the supply and demand for raw milk. Currently, the BFP is intended to represent the interaction of supply and demand for manufacturing milk and thereby, the supply and demand for fluid milk at a minimum level. A replacement that fits this traditional role suggests that the supply and demand for manufacturing milk should be reflected in the new price.

Sound economics also implies that minimum prices for milk used in manufactured products will be market-clearing. The use of two classes to price milk used in traditional "surplus" products of butter, nonfat dry milk, and cheese (that is, milk in excess of that amount needed to fill fluid demand), helps assure that only one product will have to be priced at a level that clears the market. The market-clearing product in most cases is butter/nonfat dry milk. (63 Fed. Reg. 4802, 4877 (1998))

The Secretary replaced the basic formula price (BFP) with a multiple component pricing system that derives component values from surveyed prices of manufactured dairy products. The

adopted pricing system determines butterfat prices for milk used in Class II, Class III and Class IV products from a butter price; protein and other solids prices for milk used in Class III products from cheese and whey prices; and nonfat solids prices for milk used in Class II and Class IV products from nonfat dry milk product prices. To translate prices of dairy commodities into class prices for milk, three factors are needed: a price discovery vehicle for butter, nonfat dry milk (NFDm), cheddar cheese and whey; the cost of processing milk into the finished product commodities; and the yield of finished product from a hundredweight of milk.

B. Determination of Commodity Prices

The Reform Final Decision established the determination of Commodity Prices for the class price formulae through a survey conducted by National Agricultural Statistics Service.

Each week NASS would survey butter, powder, cheese and whey manufacturers for their sales prices and volumes sold. Monthly class prices would be determined by performing a volume-

weighted average calculation of the weekly prices. The Secretary described the NASS survey!

in the December 2000 tentative decision to the congressionally mandated class III and IV Formulas Hearing:

plant plan In developing these commodity surveys, input was obtained from the dairy industry on the appropriate types of products, packaging and package sizes to be included for the purpose of obtaining unbiased representative prices. A sale is considered to occur when a transaction is completed, the product is shipped out or the title transfer occurs. In addition, all prices are f.o.b. the processing plant/storage center with the processor reporting the total volume sold and the total dollars received or the price per pound. NASS Dairy Products Prices reports wholesale cheddar cheese prices for both 500-pound barrels and 40-pound blocks, USDA Grade AA butter, USDA Extra Grade or USPH Grade A non-fortified dry milk and USDA Extra Grade non-hygroscopic dry whey. (65 Fed. Reg. 76832, 76837 (1999))

2000

The Secretary has addressed the appropriateness of combining the prices of 40-pound blocks and 500-lb barrels of cheddar cheese, adjusted to 38 percent moisture and plus three cents

per pound (0.03/lb.) to determine the commodity price for the protein formula. For the Class Price Hearing held in 2000, the Secretary wrote:

The hearing record provides no basis for altering the composition of cheese prices surveyed for use in the Class III pricing formulas or for changing the calculation of the NASS weighted average cheese price other than the moisture adjustment to 38 percent for 500-pound barrels. (67 Fed. Reg. 67906, 67926 (2000))

February 2007
2002
During the ~~2006~~ make allowance hearing, proposals were made to eliminate barrels from the calculation of the weighted average cheese price and/or eliminate the three cent addition to the 500-pound cheddar cheese prices.

During the hearing proponents asserted that since the price difference between blocks and barrels is almost zero, it can be concluded that any packaging cost difference must also be nearly zero. The Secretary disagreed and noted:

This decision does not find a causal relationship between selling prices and costs. While evidence does support that market prices of blocks and barrels can sometimes be identical, it cannot be concluded that any purported cost difference arising from packaging cost differences must have also disappeared. The sometime relatively similar market prices of block and barrels could be explained by a multitude of factors not relating to manufacturing and packaging costs. (73 Fed. Reg. 35306, 35328 (2006))

2008
February 2007
Another proposal put forward in the ~~2006~~ Hearing would have eliminated the barrel cheese price from the protein calculation. Citing that barrel production is often in excess of 50 percent of the volume of cheese in the survey, the Secretary rejected the proposal and noted, "Eliminating the barrel price from the protein price formula would significantly and needlessly reduce the volume of cheese used in the Class III product price formula which could lead to protein prices that are not as representative of the national cheese market." (Id.)

(73 Fed. Reg. at 35328 (2008))

Barrel cheese continues to be a major portion of the DPPSR cheese survey. During 2014, barrel cheese comprised 45 percent of the reported cheese sales.

http://future.aae.wisc.edu/data/weekly_values/by_area/1622 and

http://future.aae.wisc.edu/data/weekly_values/by_area/1624

The use of national dairy commodity prices for national Class 1 prices has been facilitated by Federal law since 2000. Public Law 106-532 passed in 2000 required persons engaged in the manufacture and sale of selected dairy products to report certain information including the price, quantity, and moisture content where applicable. Any manufacturer that processes and markets less than 1 million pounds of dairy products per year was exempt from the sales reporting requirements. USDA completed the rule making process on June 17, 2008 creating the Dairy Products Mandatory Reporting Program. This program collects, evaluates aggregates, verifies, and disseminates dairy products sales information to the public.

The Mandatory Price Reporting Act of 2010 required USDA to release dairy product sales information on or before Wednesday at 3:00 pm (unless affected by a Federal Holiday.) The act also required the establishment of an electronic mandatory sales reporting system for dairy products reported under Public Law 106-532.

The Act transferred the responsibility for the weekly reporting from NASS to AMS, which now issues the National Dairy Products Sales Report (NDPSR) each Wednesday. The congressionally enacted mandatory reporting captures all applicable sales of the standardized commodities, butter, NFD, cheddar cheese and dry whey. The list of "Policies and Procedures for Dairy Product Mandatory Reporting Program" is Cooperatives' Exhibit 6.B (3 pgs.) Moreover, AMS was directed to audit the reporting manufacturers, such that AMS visits the larger entities that account for 80 percent of the previous year's product at least annually. AMS

visits the entities representing the residual 20 percent of volumes every other year. In 2012 AMS reported in the Final Rule that 18 entities representing one or more plants reported cheddar cheese sales of 40 pound blocks; 14 reporting entities reported cheddar cheese sold as 500 pound barrels; 19 reporting butter entities; 28 reporting entities of NFDM sales and 20 dry whey entities.

C. California is a Major Factor in Determining Monthly NDPSR Prices.

California produced 2.4 billion pounds of cheese from 60 cheese plants during 2014 according to the NASS 2014 Annual Report. This total production of cheese represented 21 percent of the total cheese produced in the United States. (Dairy Products 2014 Annual Summary, pg. 30) California produced 375 million pounds of cheddar cheese from 19 plants, representing 11 percent of the nation's total. (pg. 32) Additionally, California produced 33 percent of the nation's butter production from 14 plants (pg. 43) and 40 percent of the nation's nonfat dry milk powder from 12 plants. (pg. 44) NASS' rules of confidentiality prohibit the disclosure of state-specific statistics when there are fewer than three reporting plants. However it is logical to assume the state responsible for 21 percent of the nation's cheese production would have an important impact on the various dry and protein-concentrated dry whey products that are byproducts from cheese production.

The Secretary addressed the relationship of California commodity dairy prices and the NASS price series in the Final Decision of the ~~2006 make allowance hearing~~ ^{2000 Congressionally mandated class III and class IV Price Formulas Hearing}. The Secretary noted: "The NASS price survey for dairy products used as a basis for establishing Class III and Class IV prices includes all dairy product prices and sales volumes in all regions of the country, including California." (67 Fed. Reg. at 67937) ⁽²⁰⁰²⁾

D. California Manufacturing Costs Have Always Been a Factor in Setting FMMO Make Allowances.

The process of determining the manufacturing cost of processing milk into butter, NFDM, cheddar cheese and whey has been iterative. During Federal Order Reform and at every make allowance hearing, testimony was provided concerning manufacturing costs of California plants. Initially for the Federal Order Reform make allowances, the Secretary relied on the manufacturing cost survey of cooperative-owned milk processing plants, conducted by the Rural Cooperative Business Service (RCBS) of USDA, a Cornell University study of processing costs and the survey of processing costs of California dairy plants, conducted by the California Department of Food and Agriculture (CDFA). The Secretary adjusted the surveys for marketing and packaging costs and return on investment. The make allowance for cheese, butter and NFDM was based on a weighted average of the CDFA and RCBS cost surveys. The FMMO Reform whey make allowance was based on a Cornell survey of whey processing costs. (64 Fed. Reg. at 16096-99)⁽¹⁹⁹⁹⁾

In 2000 the Secretary was issued a Congressional mandate to reconsider the Class III and Class IV pricing formulas included in the Final Rule for the consolidation and reform of Federal milk orders. The mandate was included in the Consolidated Appropriations Act, 2000 (Pub. L. 106-113, 115 Stat. 1501). Subsequently a public hearing to consider proposals submitted by the industry to change the pricing formulas in the marketing agreements and the orders regulating the handling of milk in the Northeast and the ten other marketing areas was held in Alexandria, Virginia, on May 8-12, 2000. (67 Fed. Reg. at 67909)⁽²⁰⁰²⁾ The Final Decision from that proceeding again relied on a weighted average of the most recent CDFA and RCBS manufacturing cost surveys for butter, NFDM and cheese.

In 2006 a national hearing was held to consider changes to the manufacturing allowances contained in the Class III and Class IV product price formulas applicable to all Federal milk marketing orders. At this hearing a new manufacturing cost survey was introduced by a college professor representing the Cornell Program on Dairy Markets and Policy (CPDMP). While the RBCS survey only included cooperative-owned plants, the CPDMP cost survey represented both cooperative-owned and proprietary plants. The CPDMP survey represented a stratified random sample of butter, powder cheese and whey processing plants, located outside of California. In the Tentative Final Decision, the Secretary described the CPDMP survey:

The CPDMP study is based on a voluntary structured survey of participating manufacturing plants selected to represent a cross sectional view of manufacturing costs for cheese, dry whey, butter, and NFDM outside of California. The CPDMP study is a first time survey and study of plant manufacturing costs designed to be relied upon in establishing make allowances. (71 Fed. Reg. 67467, 67484 (2006))

Even though the CPDMP was contracted, in part, by USDA for determining manufacturing costs of butter, powder, cheese and whey plants, the Secretary chose to also consider the most recent CDFA survey in order to determine make allowances for Class III and Class IV in all Federal orders. He wrote:

While CPDMP's study provides improved manufacturing cost data for plants in the Federal milk order program, combining it with the additional information available in the CDFA survey establishes a superior set of data on which to determine revised make allowances. Specifically, this tentative final decision finds agreement with the proponents of Proposal 1 that combining the CDFA survey with costs representative of Federal order manufacturing costs for cheese, NFDM, and butter (except dry whey) is the most reasonable approach for determining changes to the make allowances. CDFA survey data should be combined with the CPDMP study results because California's production volumes of cheese, dry whey, NFDM and butter are of such national significance it would be unreasonable to ignore California plant's

manufacturing costs in the Class III and Class IV product price formulas. (Id. at 67486) (2006))

In the case of pricing other solids the Secretary wrote:

This tentative final decision finds agreement with proponents such as Kraft, Glambia, Lactalis, Saputo, and Leprino, that the CPDMP study's weighted average manufacturing cost of dry whey plus a marketing cost factor of \$0.0015 per pound best represents the cost of dry whey for plants outside of California. (Id. at 67487) (2006))

Again in 2007 a national hearing was held to consider amendments to the Class III and Class IV formulae. And again the Secretary addressed the question of manufacturing cost surveys to determine the make allowance. The Secretary concluded:

CDFA data represents the cost survey of only California processing plants. It is important to Federal order classified pricing that Class III and IV prices be derived, as much as possible, from national estimates of manufacturing cost information and because NASS survey prices include California. Accordingly, it is reasonable to conclude that appropriately combining this cost data with the cost survey of plants not located in California will tend to produce a measure of national manufacturing costs. Doing so will tend to not bias manufacturing costs measurements that may otherwise result from the exclusive use of one set of cost survey data over another. (73 Fed. Reg. at 35324) (2008))

The current make allowances are a result of the 2007 hearing. Specifically, the butter make allowance was derived through a NASS volume weighted average of CDFA and CPDMP manufacturing costs, plus a marketing cost adjustment of \$0.0015, and is \$0.1715 per pound of butter. The NFDM make allowance was also derived through a NASS volume weighted average of CDFA and CPDMP manufacturing costs, and is \$0.1678 per pound of NFDM. (Id. at 35325-26) (2008))

The Secretary found flaws with the CPDMP data regarding cheese make allowances and found that the CDFA survey provided the only viable manufacturing cost survey. Hence, the current make allowance in all Federal orders for cheese is the 2006 CDFA average cheese

manufacturing cost of \$0.2003 per pound. Since CDFA was not satisfied with the precision in estimating the average cost to produce whey products, the Secretary relied only on the CPDMP whey cost survey which yielded a \$0.1991 per pound make allowance. (Id. at 35326) ⁽²⁰⁰⁸⁾

E. Product Yields: Cheese

The Final Decision of Federal Order Reform established the Class III price as a function of a Protein Price and an Other Solids price. The Protein Price would be derived through the following equation

$$\text{Protein price} = ((\text{NASS cheese survey price} - 0.1702) \times 1.405) + (((\text{NASS cheese survey price} - 0.1702) \times 1.582) - \text{butterfat price}) \times 1.28)$$

In explaining the equation the Secretary wrote:

The factors used in the formulas for computing component prices are determined by the quantity of the component in the commodity, except for protein, for which the Van Slyke yield formula is used. In the protein formula, the 1.405 and 1.582 are yield factors derived from the Van Slyke cheese yield formula. Both the 1.405 and 1.582 factors are determined by calculating the change in cheese yield if an additional tenth of a pound of protein or butterfat is contained in the milk, holding everything else constant.

The [Federal Order Reform] proposed rule used a 1.32 factor times the cheese price for use in computing the protein price. The change to a factor of 1.405 reflects the use of true protein as the basis for payments for protein rather than using a measurement of “total nitrogen” for the protein content of milk. The resulting protein price will be for a pound of “true protein.” (64 Fed. Reg. at 16098) ⁽¹⁹⁹⁹⁾

The result of the congressionally mandated Federal order hearing held in 2000 was a change in the protein formula to recognize a price for butterfat in Class III products. The Department’s decision to establish separate Class III and Class IV butterfat prices was subsequently modified by a set of Court-ordered formulas that were implemented in January 2001.

In November 2002 the Secretary promulgated a Final Decision for the Congressionally-mandated hearing held in 2000. After testimony was presented regarding farm-to-plant losses of butterfat and nonfat solids, butterfat retention in cheese, and assumptions regarding casein percentages in true protein, and their effects on the protein formula. The Secretary changed the protein formula to

$$\text{Protein price} = ((\text{NASS cheese survey price} - 0.165) \times 1.383) + (((((\text{NASS cheese survey price} - 0.165) \times 1.572) - \text{butterfat price} \times .9)) \times 1.17) \text{ (67 Fed. Reg. 67930 (2002))}$$

In 2006^{and 2007}, two national Federal hearings were convened to consider changes in Class III and Class IV pricing. Testimony was offered concerning cheddar cheese yields, farm-to-plant losses and the differential value of whey cream and butter as compared to Grade AA butter and their effects on the protein formula. Other than adjusting the cheese make allowances, the Secretary found no compelling evidence to change the protein formula.

The current formula for protein is:

$$\text{Protein price} = ((\text{NDPSR cheese survey price} - \$0.2003) \times 1.383) + (((((\text{NDPSR cheese survey price} - \$0.2003) \times 1.572) - \text{butterfat price} \times .9)) \times 1.17)$$

F. Product Yields: Other Solids

As noted earlier, USDA recognized the value of cheese and whey to calculate the Support Price for cheese until the 1985 Farm Bill. AMS used the Farm Bill yields and make allowances in the calculation assumptions of the Basic Formula Price adjustments. Given the mandates of the 1995 Farm Bill to determine multiple component prices, the Department returned to determining the value of milk used to produce cheese through the product values of cheese and whey.

While pre-reform orders priced other solids in milk used to produce cheese as a residual of the Basic Formula Price after values for protein and butterfat were subtracted, Federal Order

Reform determined the Other Solids value in Class III milk through the value of whey. The Secretary wrote in the Final Decision:

A value for other solids is included in Class III to assure that the Class III price reflects most of the value of milk used in Class III products. In the Federal milk orders currently pricing three components, the other solids price is determined by subtracting the value of butterfat and protein from the BFP. In this final rule the other solids price is established independently of the butterfat and protein price. Even though there is not a market for other solids as such, the dry whey price was determined to be the best indicator of value for other solids and provides a method of accounting for and distributing the value in Class III milk that is not accounted for in the protein and butterfat components. Other potential price series that could be used to determine the value of other solids were whey protein concentrate and lactose. Under present market conditions, dry whey offers more market activity with less specialization than either whey protein concentrate or lactose, and therefore constitutes a better price series for determining a minimum Federal order price. Comments filed by several parties supported the use of dry whey for the determination of the other solids price. The 0.968 factor in the formula represents the pounds of solids contained in a pound of dry whey. (64 Fed. Reg. at 16099^{x (1999))})

The Other Solids price was again considered at the 2000 Hearing and a Tentative Final Decision was issued on December 1, 2000. While there were proposals to change the yield factor, the Secretary chose to continue the .968 yield factor. (65 Fed. Reg. at 76847⁽²⁰⁰⁰⁾)

Due to the Court mandate, the Department reissued the Final Decision to the 2000 hearing. As a result the Final Decision adjusted the Other Solids formula to account for farm-to-plant losses of butterfat and nonfat milk solids. No testimony was offered^{to} change the yield factor. Additionally, the Secretary chose to convert the formula yield factor from a divisor to one with a multiplier. The²⁰⁰² Final Decision Other Solids formula was (NASS Whey Price - \$0.150) x 1.03. (67 Fed. Reg. at 67930⁽²⁰⁰²⁾)

As a result of the 2006 Make Allowance Hearing the current Other Solids formula is:

Other Solids Price = (NDPSR whey price - \$0.1991) x 1.03.

G. Product Yields: Butter

Federal Order Reform changed butterfat pricing from a calculated butterfat differential reported by the Department with the monthly Basic Formula Price, to a formula based on the NASS butter price series, less a make allowance divided ~~o~~ (or times) yield factor. The Reform Final Decision formula was (NASS Grade AA Butter Price - \$0.114) / 0.82. There were no changes to the .82 divisor as a result of the 2000 hearing.

The 2002 Final Decision changed the butterfat formula to recognize farm-to-plant losses and also changed the yield factor divisor to a multiplier. (NASS Grade AA Butter Price - \$0.115) x 1.20. (67 Fed. Reg. at 67920) ⁽²⁰⁰²⁾

As a result of testimony from the ~~2006~~ ²⁰⁰⁷ national Class III and Class IV hearing the butterfat yield was changed to correct a mathematical error from the 2002 Final Decision that over-compensated processors for farm-to-plant loss. As a result, the butterfat formula was changed to (NASS Grade AA Butter Price - \$0.1715) x 1.211. (73 Fed. Reg. at 35326) ⁽²⁰⁰⁸⁾

The current Federal order butterfat price formula is

$$\text{Butterfat Price} = (\text{NDPSR butter price} - \$0.1715) \times 1.211$$

H. Product Yields: Nonfat Dry Milk

The Federal Order Reform formula for the Nonfat Solids price was developed to recognize the amount of solids in nonfat dry milk with an adjustment for the small amount of buttermilk powder that was made in conjunction with the manufacture of butter and NFDM. (65 Fed. Reg. at 76843) ⁽²⁰⁰⁰⁾ The FMMO Reform Final Decision Formula was (NASS Nonfat Dry Milk Price - \$0.137) / 1.02.

As a result of testimony regarding the yields of NFDM and buttermilk powder from producer milk and plant to farm losses of components the formula was changed in 2002 to (NASS Nonfat Dry Milk Price - \$0.14) x .99. (67 Fed. Reg. at 67924) ⁽²⁰⁰²⁾

There were no changes to the Nonfat Solids yield factors as a result of the 2006 hearings. The current nonfat milk solids price is:

Nonfat Milk Solids = (NDPSR Nonfat Dry Milk Price - \$0.1678) x .99

The Final Rule for the current make allowances and product yields was signed on February 1, 2013.

IV. Federal Order Reform Resulted In Uniform National Class II Pricing.

Citing the substitutability of NFDM and butterfat in the manufacture of Class II products, the Final Decision of Federal Order Reform changed the relationship of Class II pricing from Class III to the new Class IV. Including advance pricing for Class II solids, the Final Decision described the pricing of milk used to produce Class II products for all Federal orders:

The price of Class II skim milk for a month will be computed by the sum of a Class IV skim price per hundredweight, calculated from product prices reported by NASS for the most recent two-week period for which prices are available on the 23rd day of the previous month, and the 70-cent Class II differential. The Class II butterfat price will be determined from the NASS-reported butter price, as in Classes III and IV, plus .7 cents per pound to incorporate the Class II differential. This price will be announced on the 5th day of the month and apply to butterfat in Class II during the previous month. (64 Fed. Reg. at 16091) ⁽¹⁹⁹⁹⁾

Federal Order Reform resolved Order 2's farm point pricing incongruity and its singular Class II location adjuster; consequently all Federal orders now share uniform Class II pricing.

V. Federal Order Reform Set National Uniform Pricing Criteria for Milk Used in Class I Products.

Prior to Federal Order Reform, each Federal order shared a uniform base price in the form of the BFP. However, each order had a defined pricing point and priced Class I milk from

that location. The consequence of such order-specific and disparate pricing was that at times the minimum price a Distributing Plant would pay for milk was dependent on the Federal order on which that plant was pooled. For example, in 1993 a Distributing Plant, located in Lansdale Pennsylvania and owned by multi-plant handler changed regulation from Order 4 to Order 2. This change in regulatory status resulted in a decrease of \$0.345 per hundredweight in Class I price for ^{the}Lansdale^{plant}. Other Class I handlers, located only miles from the Lansdale^{plant}, competed in the same Philadelphia marketplace for sales with different base prices. Additionally dairy farmers had their pay affected; producers, long pooled on Federal Order 4 and possessing earned Order 4 bases, were required to change their regulatory status to Order 2 to maintain the customer sale.

Disparate Class I pricing between orders was addressed and solved in Federal Order Reform. First, the 31 Federal orders were consolidated to 11 and second a national Class I pricing grid was adopted in all Federal orders. The Final Decision of Federal Order Reform noted:

Although not required by the 1996 Farm Bill, the legislation provided authorization for the Secretary to review the Class I price structure as part of the consolidation of the orders including the consideration of utilization rates and multiple basing points for developing a pricing system. In any event, the consolidation of orders requires the review of the pricing system because historically, Class I pricing provisions, as well as other Federal order provisions, have been reviewed primarily on an individual market basis. The reform effort provides the opportunity to consider and establish a nationally coordinated Class I pricing surface that uses location adjustments to the differential levels to price milk for fluid use in every county in the United States. (64 Fed. Reg. at 16108) (1999)

Class I prices are set based on the higher of the Class III or IV advance price as determined by AMS and by adding a specific Class I differential. Section 1000.52 lists the Class I differentials for all counties in the United States, including California.

The Cooperatives recommend that this section be included in the California order in Sections 1051.51 and 1051.52. The national pricing grid establishes five differential zones in the proposed California marketing area. They range from \$2.10 in the San Diego-Los Angeles area; \$2.00 in the southeast corner of the state; \$1.80 from the east and north from the \$2.00/\$2.10 zones, north up the Pacific coast including the San Francisco and Bay areas to Oregon; \$1.60 in the heaviest production areas; and the \$1.70 zone, north of the \$1.60 region and bordering Nevada and Oregon. (Exhibit 20, Map 1.D)

These differentials were developed during the Federal Order Reform process and represent the spatial value of milk and its components across the United States. AMS relied on the United States Dairy ~~Market~~ ^{Sector} Simulator Model (USDSS) to estimate relative geographic values of milk and place them on a national grid which assigned Class I location values for each county in the U.S. (64 Fed. Reg. at 16108) ⁽¹⁹⁹⁹⁾ The Congress of the United States through the Consolidated Appropriations Act of 2000 (P.L. 106-113, 115) overruled the Secretary's choice of a Class I Pricing Grid and instructed the Secretary to apply Option 1-A to all Federal orders. The Federal Register of December 17, 1999 lists all counties of the United States, including counties of California, and the Class I differentials associated with each. (64 Fed. Reg. 70868, 70871 (1999))

As noted, the other factor in determining minimum Class I prices is the higher of the Advance Class III or Class IV price. The Final Decision for Federal Order Reform lists three reasons why the Class I Mover should be determined by the higher of the Advance Class III or Class IV price. First, Class I is always in competition with processors of manufactured dairy

products. Federal Order Reform provided for four distinct classes of milk. Setting the Class I price at the higher of Class III or Class IV guarantees that the Class I price is related to the higher valued price used to produce manufactured products. The Secretary noted, “Since Class I handlers must compete with manufacturing plants for a supply of milk, the Class I price must be related to the price of milk used in manufacturing.” (64 Fed. Reg. at 16102)⁽¹⁹⁹⁹⁾

Second, due to advanced Class I pricing, price signals to producers may lag. It is especially important in a rising market that producers receive the price signal to increase production. In the Final Decision of Federal Order Reform, the Secretary wrote:

Since the Class I price is announced in advance, in a rapidly changing market the Class I price may not reflect the value needed to compete for the necessary raw milk supply or the Class I price may be overvalued relative to the raw milk price. Undervaluing Class I milk is a particular problem since it reduces producers’ pay prices at a time when the producers should be receiving a positive price signal. (Id.)⁽¹⁹⁹⁹⁾

The third reason cited in the Final Reform Decision relates to decreasing the likelihood of price inversions and the resulting de-pooling of producer milk, when the higher of Class III or Class IV is utilized in the formula. The Cooperatives’ proposal addresses the question of de-pooling through its mandatory pooling provision. Thus, the third reason, cited in the Final Reform Decision is not applicable to this proposal.

Also addressed in Federal Order Reform was the appropriateness of the utilization of the minimum \$1.60 per hundredweight base Class I price. As noted, the USDSS estimates the relative differences in the value of milk between geographic points. Due to geographic characteristics of supply and demand, one or more points are found to be base pricing points. The central valley of California is one of the model’s base points. Federal Order Reform set the price at these basing points at \$1.60 per hundredweight.

The Secretary clearly stated the need to set the base differential at \$1.60:

The \$1.60 minimum differential proposed is perceived to be the lowest value necessary under present supply and ^{demand} supply conditions to maintain stable and viable pools of milk for Class I use in markets that are predominantly manufacturing oriented. (63 Fed. Reg. 4802, 4909 (1998))

The \$1.60 minimum has three components as presented by USDA in the Recommended Decision of Federal Order Reform. The first had to do with the cost of a producer maintaining Grade A status. The requirements for maintaining Grade A status include possessing and maintaining an approved water system; ^{and supply} facility construction and appearance requirements; plumbing requirements and specific equipment. It was noted that maintaining Grade A status would require additional labor resource and utilities expense. USDA in ¹⁹⁹⁸ 1999 estimated the additional cost to be ^{\$0.40} ~~\$0.60~~ per hundredweight. (63 Fed. Reg. at ^{4908 (1998)} ~~4909~~) ^{See Exhibit 71, Exhibit 6.C Dairy Farm Score card}

The Secretary also cited marketing costs as they pertain to the buildup of the base differential:

These marketing costs include such things as seasonal and daily reserve balancing of milk supplies, transportation to more distant processing plants, shrinkage, administrative costs, and opportunity or "give-up" charges at manufacturing milk plants that service the fluid Class I markets. (Id.) ⁽¹⁹⁹⁸⁾

The Secretary noted that these marketing costs are approximately \$0.60 per hundredweight.

Additionally, the Secretary noted that in the upper Midwest, Class I handlers competed for milk with processors of manufactured milk. The Secretary estimated that 2/3 of the competitive premium was \$0.60 per hundredweight.

Further justification of the \$1.60 base differential for the California order is found in the Cooperatives' Transportation Credit proposal. This unique provision provides payment to

handlers servicing the Class I market from the Order's pool and is estimated by the Cooperatives to decrease the pool by \$0.09 per hundredweight. Assuming a 15 percent Class I utilization in the California order, the value to the Order's Class I handlers is \$0.60 per hundredweight.

VI. The California Order Should Adopt the Federal Order Class I Pricing Formulae and Differentials

Changing Class I prices in California, either through adjusting the differentials, including the base differential, or by modifying the Class I mover formula would change the relationship of Class I prices in the western part of the county. Through its state order, California's Class I pricing has limited effect on the adjoining Federal orders. However, as a Federal order, California Class I pricing could affect packaged regional milk sales. An increased California Class I price would not change the national Class I price grid and would only affect California counties. However, a decreased California Class I price, may encourage exports of California milk and would provide an inappropriate price advantage in moving packaged milk into adjoining Federal order markets.

Since Reform, AMS has only changed the Class I differentials found in Section 1000.52 once as a result of a hearing held in May 2007 for FMMOs 5, 6 and 7. That Decision to increase the differentials within the marketing areas was based on testimony that the Southeast was experiencing an increase of demand concurrent with a decline in milk production. All three marketing areas were described as milk deficit. Adjustments to the county differentials were based on a transportation cost function from the nearest surplus supply region to the Southeast markets. (73 Fed. Reg. 11194 (2008)) None of the supply-demand factors, referenced in the Southeast decision are present in California.

VII. Concluding Discussion

The 1996 Farm Bill specifically provided for the inclusion of California as a separate Federal milk order, but the provision was contingent upon petition and approval by California producers. Throughout the Reform process as well as the amendatory hearings, California interests have participated as individual processors, through the dairy processor and producer trade associations, the Dairy Institute of California, and through CDFA. Citing their concern that producer groups would petition for a California Federal order, the Dairy Institute submitted 29 pages (including attachments) of comments to AMS on April 29, 1998 in response to the Reform Recommended Decision. Comments by the Dairy Institute of California were twice cited in the Final Reform Decision. The first citation was to support the inclusion of Las Vegas with Arizona in order to eliminate competitive distortions between those areas and California. (64 Fed. Reg. at 16078⁽¹⁹⁹⁹⁾) Additionally, the Dairy Institute was cited in the Reform Final Decision regarding their comments pertaining to product formulae make allowances and yields. (Id. 16098-99⁽¹⁹⁹⁹⁾)

Additionally, two employees of CDFA gave testimony at the 2006 Make Allowance hearing. They were Kelly Krug, Director of Market Services and Venetta Reed, Supervising Auditor. They described in detail the procedures involved in the CDFA Manufacturing Cost Survey and the determination of the make allowances included in the CDFA class price formulas. The witnesses noted the distinction between the results of the CDFA Manufacturing Cost Survey and the make allowance factors included in CDFA's class pricing formulae. They noted that the CDFA decision process did not merely input the average plant cost into the price formulas. In addition to the reported manufacturing costs, Mr. Krug said that the formulae make allowances included "supply, demand and relationships between classes. There are many factors

that are considered.” He answered affirmatively to the question regarding the establishment of make allowances in California, “So it becomes a policy decision, not a mechanical process.”

(1/24/2006 Transcript of hearing, Pg. 182)

Addressing comments pertaining to regional milk pricing the Secretary states plainly in the Final Decision of FMMO Reform, “This decision replaces the current BFP with a national Class III price and a national Class IV price. “ (64 Fed. Reg. at 16100⁽¹⁹⁹⁹⁾) Component pricing solved the issue of regional yields; the NASS survey reported average national commodity sales prices; and, the product make allowances determined an average national product manufacturing cost by combining the costs of manufacturing within California with plants located outside of California. (67 Fed. Reg. at 67937⁽²⁰⁰²⁾)

Addressing comments regarding pricing relationships with California, the Secretary wrote:

Class III and Class IV dairy products compete in a national market. Because of this, Class III and Class IV milk prices established for all Federal milk marketing order areas are the same. The Federal milk order program gradually adopted the Minnesota-Wisconsin (M-W) price as the Class III price in all Federal milk marketing orders. Although the M-W was first adopted in 1963, it was not until the mid-1970's that the M-W established a uniform class price for milk used in Class III products in all Federal milk orders. Observations of the market place for cheese, butter, and nonfat dry milk provided the basis for concluding that these products compete in a market that is national in scope. Such findings were upheld with the adoption of the Basic Formula Price (BFP), which provided an interim pricing method for milk (due largely to the declining statistical reliability of the M-W price series) until a more long-term pricing method could be developed.

The implementation of milk order reform in January 2000 continued finding that Class III and Class IV dairy products compete in a national marketplace. However, a competitive price for milk, as represented by the M-W and BFP prices, was no longer viable. As an intended long-term method, the Federal milk order program has adopted end-product price formulas, valuing

Class III and Class IV milk on the basis of the value of Class III and Class IV end-products in the marketplace. The NASS price survey for dairy products used as a basis for establishing Class III and Class IV prices includes all dairy product prices and sales volumes in all regions of the country, including California. In this regard, the Federal order program has and will continue to reflect California's impact on dairy product prices while establishing Class III and Class IV prices that are reflective of national supply and demand conditions. (67 Fed. Reg. at 67937) ~~(2002)~~

The implication from a paragraph from the ~~2002~~¹⁹⁹⁹ Final Decision is very telling of the Secretary's intention to accommodate California's entry into the Federal order system:

The Omnibus Consolidated and Emergency Supplemental Appropriations Bill, passed in October 1998, extended the time for implementing Federal milk order reform amendments from April 4, 1999 to October 1, 1999. The legislation provides that California has from the date of issuance of this final decision until September 30, 1999, to become a separate Federal milk order. This additional time is intended to allow California dairy interests the opportunity review this final decision to determine whether a Federal milk order for California, consistent with the provisions adopted for the consolidated orders, would best meet their milk marketing regulatory needs. (64 Fed. Reg. at 16044) ~~(1999)~~

Since federal order reform, the manufacturing costs of California plants and the price of commodity dairy products sold in California have and will continue to be an integral part of the uniform national Federal order class prices. It is now time for those prices to be applicable to the milk produced on California dairy farms.

VIII. Announcement of Class Prices, Component Prices and Advanced Pricing Factors.

The Cooperatives propose that the California Federal Order adopt the class component and advanced pricing factors listed in Section 1000.53, with the exception of Section ~~1000(a)~~^{1000.53(a)}

11: "The Somatic Cell Adjustment Rate." The timing and manner of these necessary price announcements are consistent with other Federal orders.

The Cooperatives are not proposing the inclusion of a somatic cell adjustment in the California order. Such an adjustment in class and producer prices has been historically at the option of the order's dairy farmers. Currently two, FMMO 1 and 124, of the six Federal orders that have multiple component pricing do not include a somatic cell adjuster. The 2014 average Class III and Class IV utilizations in the Northeast order were 25.8 percent and 14.6 percent. Class III and Class IV utilizations in the Pacific Northwest order were 35.8 and 31.9 percent, respectively. For the same period CDFA reported that the Class 4b utilization was 45.8 percent and the Class 4a utilization, 33.0 percent.

IX. Equivalent Price

The Cooperatives propose that the California Federal Order adopt the equivalent price provisions in Section 1000.54. This provision provides the Market Administrator the authority to use an equivalent price, provided by the Deputy Administrator of Dairy Programs, in the event that a constituent pricing factor required by Section 1051.50 is unavailable. This Proposal will aid in the effective and efficient administration of the order.