

# Land O'Lakes, Inc.



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Dairy Foods

September 27, 2005

MS. Dana Coale, Deputy Administrator  
USDA – AMS – Dairy Programs  
1400 Independence Avenue, SW  
Washington, DC 20250-0225

Re: Request for Emergency Hearing on Class III and IV Make Allowances

Dear Ms Coale,

Land O'Lakes joins Agri-Mark and other parties in requesting a Federal Order hearing to update the cost calculations that determine the Class III and IV make allowances.

Land O'Lakes is a Capper-Volstead cooperative with a national membership base of 3,500 dairy-farmers, pooled on six federal orders. Land O'Lakes operates numerous dairy manufacturing plants throughout the United States and is very aware of the differences in current processing costs from those cited in the hearing record of the May 2000 hearing. That hearing record established the current make allowances. Land O'Lakes is prepared to testify regarding current costs at its cheese and butter/powder plants and we believe the difference in processing costs justify an emergency hearing.

The May 2000 Hearing record included 1998 and 1999 costs from federal order and California manufacturing plants. Current processing costs are not reflective of those base surveys. For example, the U.S. Energy Information Administration reports that the national average price of commercial natural gas was \$5.48 per mcf in 1998, compared to an average price of \$9.26 in 2004, representing an increase of almost 70-percent for a critical processing input. Other processing inputs have also increased during the six-year period. The California Department of Food and Agriculture (CDFA) annually collect and audit processing costs from the state's manufacturing plants. The weighted average processing costs for butter, powder and cheese in 1999 were \$0.096; \$0.136 and \$0.169, respectively. The most recent (2003) CDFA weighted average processing costs were \$0.1299; \$0.1560 and \$0.1706 for the same commodities. Land O'Lakes believes these changes in processing costs adequately justify an emergency hearing.

Specifically Land O'Lakes requests that the make allowances contained in Section 1000.50 (l), (m), (n), (o) and (q) be updated to reflect current processing costs. These sections

define the butterfat, non-fat solids, protein, other solids and advance butterfat prices under the federal orders. In order to expedite a decision on this hearing, Land O'Lakes proposes that the Hearing Call specifically limit testimony to processing costs and leave yield and product pricing issues for another hearing.

In the Federal Order Reform Final Rule and the Final Decision of the May 2000 Hearing [Docket No. AO-14-A69, et al.: DA-00-03] the Secretary outlined a process of collecting information from various cost surveys to determine manufacturing and processing make allowances. In the Final Decision of the May 2000 Hearing the Secretary relied on the cost data contained Rural Cooperative Business Survey (RCBS) and the CDFA Manufacturing Cost Survey to determine the current make allowances. Currently the RCBS is collecting 2004 processing cost data from cooperatives that operate manufacturing plants and a CDFA is expected to release its 2004 Manufacturing Cost Survey before year's end. At the Hearing, processing costs were submitted by other parties, but they were found defective for various reasons. Land O'Lakes proposes that the Department be open to all manufacturing costs surveys submitted by interested parties engaged in operating cheddar cheese and butter/powder plants.

Through Federal Order Reform and other Decisions, the Secretary has repeatedly stated that the Class III and Class IV prices are meant to represent market clearing prices. To that end, the Secretary has adjusted the relative weighting of the cost surveys so that balancing costs are reflected in the make allowances. When the make allowance formulae no longer represent current processing costs, those handlers who provide a market balancing function suffer the greatest pain. As already stated, Land O'Lakes operates a multiple manufacturing plants with in the federal order system.

Land O'Lakes respectfully requests that the Secretary convene an emergency hearing to address manufacturing make allowances for federal order class prices. If you have any questions, please feel free to contact me at (717) 486-2276.

Sincerely,



Dennis J. Schad  
Land O'Lakes  
Director of Regulatory Affairs

**Before the United States Department of  
Agriculture  
Agricultural Marketing Service**

In the Matter of Proposed Amendments :	:	Docket Number
:	:	:
to Tentative Marketing Agreements :	:	AO-14-A74, et al.
:	:	:
and Orders :	:	DA-06-01

**Testimony of Dennis J Schad  
On Behalf of Land O'Lakes, Inc**

**January 24, 2006**

Exhibit \_\_\_\_\_

My name is Dennis Schad and I am here to testify on behalf of Land O'Lakes, Inc. My business address is 405 Park Drive, Carlisle PA. I hold a bachelors degree in History from the College of William and Mary and a Masters in Business Administration from Virginia Tech. I have worked for Land O'Lakes and its predecessor cooperatives for twenty-five years and my current title is Director of Regulatory Affairs. Prior to this assignment, I have held positions in cooperatives' marketing and transportation departments. I have testified at numerous Federal and state milk marketing order hearings and before the agriculture committees of several state legislatures.

Land O'Lakes (LOL) is a dairy cooperative with over 4,000 dairy farmer member-owners. The cooperative has a national membership base, whose members are pooled on six different Federal orders. Land O'Lakes owns numerous cheese plants and a butter/powder plant. These plants are regulated under the Federal orders.

I testify today in support of Agri-Mark's proposal to update the manufacturing cost indices used to determine butter, nonfat dry milk powder, cheese and dry whey powder.

### **Background of Determining Class Prices**

Through the informal rulemaking process of Federal Order Reform and the Final Decision of the 2000 Class III and IV Hearing, USDA has developed a process to determine class prices. This process that sets Class III and IV prices replaced the M-W and Basic Formula Price Series. Theoretically Class III and IV prices are now the residual of the market price of a commodity (butter, NFDM, cheese or whey) less the cost of converting milk to that commodity.

Determining the class prices starts with the NASS price series, which describes commodity-specific products, cheddar cheese in 40 pound blocks and 500 pound barrels; butter in 25 kilogram and 68 pound boxes and NFDM and whey in "bag, tote or tanker sales." NASS reports the total price received at plants for the commodities. During the last few years, DairyAmerica, a NFDM selling marketing agency-in-common, increased its selling price of NFDM in recognition to increased energy costs. Naively, DairyAmerica believed that a line item energy surcharge would not be captured in the NASS survey and the surcharge could be passed back to the

manufacturing plant. In actual practice, NASS captured the DairyAmerica energy surcharge in its reporting of the selling price of NFDM.

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

The second step of the process is to determine the cost of converting milk to the commodity whose price is quoted in the NASS survey. The Department is scrupulous in making sure that commodity manufacturing costs are tied to the product described by the NASS survey. For instance, in the Federal Order Reform process and the Final Rule from the 2000 Hearing, USDA subtracted the butter packaging cost from the RCBS survey and substituted the CDFA butter packaging costs. The reason for the substitution was that the CDFA costs better reflected the costs of bulk butter, while the RCBS cost represented the costs of packaging print butter. The NASS butter price reports the market selling price of bulk butter.

The residual of this calculation is the Class III or IV price. The price is designed to be the minimum regulated class price for the commodity. Additionally, USDA defines the Class IV price to be the market clearing price and explicitly adds a component for balancing costs in the make allowance for Class III and IV.

### **Background of the Current Make Allowance Calculation**

The Federal Order Reform and 2000 Class III and IV final decisions set forth a process to determine make allowances. USDA averaged the costs of cooperatively-owned manufacturing plants with the costs reported by the plants regulated by the California Department of Food and Agriculture (CDFA). The costs at the cooperatively-owned plants are reported by the Rural Cooperative Business Service of USDA (RCBS). Manufacturing costs were presented at the 2000 Hearing by other interested parties, however, USDA found them lacking in specificity or design.

For the Final Decision of the 2000 Hearing USDA combined the weighted average of all California cheese plants with the RCBS weighted average to set the make allowance for cheese to be used in the Federal orders. For NFDM, the weighted average of the two lower cost subgroups of the CDFA



survey were combined to set the NFDM make allowance to be used in the Federal orders. For butter, USDA combined the highest cost subgroup of California butter plants with the RCBS weighted average to set the butter make allowance. For whey, USDA adopted a make allowance of \$0.159, reflecting a higher drying cost compared to NFDM and the NCI reported cost.

USDA recognized that the RCBS survey did not include all relevant manufacturing costs. To approximate the costs associated with return on investment and general and administrative costs, USDA added to the RCBS costs the reported ROI or G&A costs from the appropriate CDFA group or subgroup. Additionally USDA added a \$0.0015 cost per pound to the RCBS and CDFA costs as an estimate of marketing costs.

Charles Ling, RCBS, has testified earlier relating to the inadvertent error contained in the calculation of the make allowances from the 2000 Hearing. The RCBS Survey from 2000 that was presented to that Hearing included two butter and two NFDM plants that were located in California. The 2000 Manufacturing Cost Annual, published by CDFA, stated that 99.5 percent of the butter and 98.9 percent of the NFDM produced in California was manufactured by the plants included in the survey. Obviously these two California butter and powder plants were included in both the RCBS and CDFA surveys.

Page A of LOL Exhibit \_\_\_ is the 1998 Dairy Product Plant Costs, as reported by RCBS at the 2000 Hearing.

Page B of LOL Exhibit \_\_\_ is the 1998 Dairy Product Plant Costs, as revised by RCBS. This report excludes the California Butter and Powder Plants.

Page C of LOL Exhibit \_\_\_ is the Calculation of the Butter Make Allowance, using the data from Page A.

Page D of LOL Exhibit \_\_\_ is the Calculation of the Butter Make Allowance, using the data from Page B.

Page E of LOL Exhibit \_\_\_ is the Calculation of the NFDM Make Allowance, using the data from Page A.

Page F of LOL Exhibit \_\_\_ is the Calculation of the NFDM Make Allowance, using the data from Page B.

Page G of LOL Exhibit \_\_\_ is the Calculation of the NFDM Make Allowance, using the data from Page B and with an alternative CDFA weighting.

When the California plants are excluded from the RCBS survey, the resulting make allowance calculation increases. Had the RCBS evidence in the 2000 Hearing been correct, it is arguable that the current butter make allowance would be \$0.1195 (LOL Exhibit \_\_, Page D), instead of the current \$0.115 per pound, and the NFDM make allowance might be \$0.1422 (LOL Exhibit \_\_. Page F), instead of the current \$0.14 per pound.

Additionally, had this evidence been available to USDA at the 2000 Hearing, the Department might have decided to weigh the California information differently. The Final Decision states:

The basis for using the two lower-cost groups of California plants is that the mid-cost group is of a similar average size as the group included in the RCBS survey, and that the lowest-cost California group has a very similar total cost to the mid-size group. (Federal Register/Vol. 67, No. 216, November 7, 2002, page 67,921).

Given this revised evidence, the Department may have concluded that the average RCBS plant size of 29.1 million pounds was not as comparable to the average Group II CDFA powder plant; and that the new RCBS cost of \$0.1711 per pound might have resulted in a different weighting selection. LOL Exhibit \_\_, page G shows the make allowance calculation had the Department chose to weigh the RCBS costs with the Weighted Average of all the CDFA powder plants. Such a calculation would have set the current NFDM make allowance at \$0.1451 instead of the current \$0.14 per pound.

#### **USDA Should Include Balancing Costs in the Make Allowances**

In the Final Decision regarding market service payments in the Northeast Order for balancing costs, USDA has made it clear that the Class III and IV make allowances include recognition for the costs of balancing. To that point the Secretary stated:

The Class III/IV Final Decision that adopted product price formulas for all Federal milk marketing orders, including the Northeast order, gave specific recognition to the costs associated with balancing in the make allowance factor in setting the Class III and Class IV milk price. ADCNE's exception is not persuasive. As already stated, the Class III/IV pricing formulae include a factor to offset the cost of balancing

performed by butter-powder plants. (Federal Register/Vol. 70, No. 19, January 31, 2005, page 4,953).

The costs of balancing the market are real. At the Federal Order 1 Market Service Hearing, Land O'Lakes submitted testimony regarding plant utilization at its Carlisle facility (LOL Exhibit \_\_, Page K). That table illustrates the function of a balancing plant to the market. In August 2001 the Carlisle plant had deliveries of total milk solids at 50 percent of capacity and only nine months later in May 2002, the plant received total milk solids at 100 percent of its capacity. As stark as this comparison is, monthly data actually mask the daily and weekly balancing demands.

Fixed costs on a per unit basis at a balancing plant are high. They are built to handle the demands of the highest days' balancing and rarely are they filled to that level for a sustained period. In most businesses labor is considered a variable expense. The firm can add or lay off workers as the work load changes. Labor at a balancing plant is treated as a fixed cost. The employees are highly trained and mobile. Reducing the work force to accommodate fluctuating milk receipts, opens the balancing plant to the risk of being under staffed at a critical time.

The Secretary acknowledged the balancing function within the butter make allowance when he opted for a weighting calculation that resulted in a FMO make allowance greater than the RCBS adjusted weighted average cost. However, the NFDN weighting choice resulted in a \$0.14 FMO make allowance when the RCBS adjusted weighted average cost was \$0.1530 per pound. In lieu of its stated recognition of the costs borne by some to balance the markets, the Secretary might have made a different weighting decision for NFDN in 2000 had the Department known the real weighted average RCBS cost was \$0.1711 per pound.

### **Land O'Lakes Supports the Agri-Mark Proposal**

Land O'Lakes owns and operates many dairy plants within the United States. Among them are two that are included the RCBS survey. They are the butter/powder plant in Carlisle PA and the cheese/whey plant in Kiel WI. Both plants were also included in the RCBS Survey presented at the 2000 Hearing. The costs supplied to RCBS were costs related specifically to manufacturing the commodity product that is contained in the NASS surveys. As all know, Land O'Lakes markets value added, branded cheese



and butter products. Except for butter packaging costs (which was adjusted by USDA in 2000), specific efforts were made to exclude any costs from the RCBS survey, related to the marketing of our branded products.

In 2003 Land O'Lakes chose to finance a portion of its business through the sale of bonds. As these bonds are currently traded on the open market, Land O'Lakes is subject to regulations promulgated by the Securities and Exchange Commission regarding insider trading. Simply put, Land O'Lakes can make no material statement regarding its operations unless the cooperative makes this information available to the general public. For that reason, I must be somewhat circumspect regarding specific information about our operations. Land O'Lakes participated in the RCBS surveys, an aggregating process which allowed for our anonymity. With that said, I can make some general statements about our various operations.

On a unit cost basis, Land O'Lakes' costs at its Carlisle butter plant are up dramatically compared to the 1999 costs. While our butter plant capacity utilization has increased, the per unit cost against almost all categories increased over the five year period.

The same is true at the Carlisle powder plant. Against virtually all categories, the unit costs were greater in 2004 compared to 1999. While total pounds produced were greater in 2004, the percentage of plant capacity declined in 2004 compared to 1999. This is due to the plant expansion at Carlisle during 2000.

The per unit costs at our cheese plant at Kiel increased only marginally compared to 1998. There are two obvious reasons for this per unit achievement in an environment of increasing costs. First, Kiel is an old plant with lower than average depreciation expenses and secondly Kiel experienced a large increase in volume through the plant during the period. Increased volumes and minimal plant investment drove the unit cost equation at the plant.

RCBS did not report whey costs in 2000, so there can be no comparison with the current reported RCBS whey drying costs. Land O'Lakes' cost of drying whey in 2004 is less than the average cost reported by RCBS. While our costs are fairly presented, we do not think them representative of the industry norms. The whey drying operation at Kiel dries the whey produced at the Land O'Lakes cheese plants in Kiel, Denmark and Greenwood WI.

Denmark and Greenwood ship their condensed whey to Denmark for drying, which allows Kiel to run at almost 100 percent capacity. The cost of the evaporation activity at Kiel was determined and that cost was used as the proxy for evaporating costs at Denmark and Greenwood. We have not had the time to test the validity of that assumption. Nevertheless, the per unit efficiency of the whey drying activity at Kiel is dependent on the three-plant system that has evolved in that area and we believe is not representative of industry norms.

### **Recommendations for CDFA and RCBS Weighting**

Land O'Lakes supports the recommendations of AgriMark relating to the weighting of the various groups and subgroups of the CDFA survey with the RCBS survey. In the Final Decision USDA used the criteria of relative plant size, comparable per unit costs and a recognition of balancing costs as criteria for choosing the appropriate California group or subgroup to combine with the RCBS survey in a weighted average calculation. While it may be expeditious to use the same group, subgroup weighting as used in 2000, Land O'Lakes recommends that USDA apply its 2000 criteria to the 2004 realities. One reason for this recommendation is the fact that the RCBS evidence from the 2000 hearing was in error, and had the Department had the correct RCBS information; it may have weighted the cost data differently.

**Butter:** Land O'Lakes recommends that USDA combine the RCBS weighted average butter cost with the California weighted average cost for all butter manufacturers (LOL Exhibit \_\_, Page H). The average RCBS plant produced 36-million pounds in 2004, while the average California plant ran 48-million pounds. Adjusting for packaging and applying the California ROI and G&A costs plus the marketing expense of \$.0015 per pound, the adjusted RCBS cost was \$0.1714 and the California cost adjusted for marketing expense was \$0.1383 per pound. The weighted average of the two groups was \$0.1515 per pound. Land O'Lakes recommends that USDA weight these two groups because the average plant size is comparable. Additionally, the result of the weighted average is very close to the current California make allowance for butter.

**Non-Fat Dry Milk:** Land O'Lakes recommends that USDA combine the RCBS weighted average NFDM cost with Group II of the CDFA powder survey (LOL Exhibit \_\_, Page I). The average production of the RCBS

group, 31-million pounds is closer to any of the subgroups of the CDFA survey (Group II is 59-million pounds). Adjusted for ROI, G&A and marketing expense the RCBS weighted average cost is \$0.1932, while the CDFA Group II adjusted average cost is \$0.1748. The current California make allowance for NFDN is more than a half cent below the most recent weighted average cost and two cents below the Group II average cost. Of all the commodities in question at this hearing, NFDN plays the strongest role in clearing the market of excess milk. Powder plants balance the markets and NFDN is characteristically the first product offered to the CCC. For these reasons, Land O'Lakes recommends that USDA use the CDFA Group II NFDN series as the weighting factor, which would provide a make allowance of \$0.1867 per pound.

**Cheese:** For this hearing RCBS offered two cheese groups, an "all cheese group and a 40-pound block group. The CDFA cheese survey reports plant costs for 40-pound blocks. In the CDFA survey, the three plants that processed 500-pound barrels or 640-blocks had packaging and packaging labor costs for 40-pound blocks substituted for the reported costs. (California Manufacturing Cost Annual 2004, CDFA, Table 1, Sections 4 and 5, page 8.) For that reason, Land O'Lakes believes the relevant comparison for cheese is the RCBS 40-Pound Block Survey and the CDFA weighted average cheese survey (LOL Exhibit \_\_, Page J). While the Group II cheese plants were closer to the RCBS average production, the cost per pound between the two groups were too great for comparison purposes. The adjusted RCBS cost was \$0.1814 and the adjusted unit cost for the weighted average CDFA was \$0.1784. The weighted average of the two is \$0.1794, which correlates well with the current California cheese make allowance of \$0.1710 per pound.

**Whey:** The Final Decision used the NCI whey cost data to determine the current make allowance for whey. At the hearing there was persuasive testimony that the cost of whey drying is greater than the cost of drying NFDN. This is the first time RCBS has released a survey of whey drying costs. The weighted average cost of drying whey, as reported by RCBS, is \$0.1155, while CDFA reports a cost of \$0.2673 per pound. The average RCBS plant produces about 10-million pounds per year while the average California plant produces about 31-million. These data is counter-intuitive. Land O'Lakes recommends that USDA consider setting the whey make allowance based on a value above the NFDN make allowance. We are

informed that others will provide data relating to the incremental cost of drying whey, compared to NFDM.

### **Summary and Conclusions**

Land O'Lakes recommends that the Department increase the butter make allowance by \$0.0365 per pound, NFDM by \$0.0467 per pound and cheese by \$0.0144 per pound. For whey, Land O'Lakes recommends that USDA set a make allowance above the cost of drying NFDM and at a rate consistent with the testimony and recommendations of Northwest Dairymen's Association and Leprino Foods. We recognize that this request represents a 31.7 percent increase in the butter make allowance; a 33.4 percent increase in the NFDM make allowance and an 8.7 percent increase in the cheese make allowance. We also point out that the testimony today represents an updating of costs over a six year period. Additionally, the evidence presented in 2000 contained an error, so it is quite reasonable to conclude that the make allowances for butter and powder have been understated during the entire period.

In the last Make Allowance Hearing, IDFA spent considerable time arguing that the Department should attempt to err on the high side when calculating the make allowances. While Land O'Lakes is a major manufacturer of butter, powder and cheese within the Federal Order system, it is also a cooperative. Our dairy farmer member-owners rely on a milk price for their living and they also expect that their investment in manufacturing assets brings a return. I would recommend to the Secretary to be like Goldilocks and get the make allowances "just right." Given that the CCC clears the market of excess butter, powder and cheese, it would be to no one's advantage in the industry to set a commodity's make allowance so high that milk flows to producing that commodity, irrespective of external market signals. On the other hand, setting make allowances too low discourages investment in the assets needed to clear the market on a daily, seasonal and annual basis. The costs of maintaining market balancing facilities must be borne by the market, not only by the owner of the facilities.

Land O'Lakes is well aware of the class price decreases that would follow from our support of the AgriMark proposal is \$0.46 in Class III price and \$0.51 in Class IV. While Land O'Lakes membership isn't happy about the changes, they recognize that they are currently paying for these increased plant costs, while the larger producer market avoids them by not owning

plants. We also recognize the longer term and more expansive analysis provided by USDA in the Notice of Hearing.

USDA's three scenarios offer insights into the producer price impacts of the changes in make allowances. Scenarios two and three increase the cheese make by 3.5 cents (from current levels) and 5 cents (from current levels) which is far above our proposed increase of 1.44 cents. All three USDA scenarios increase the butter make 4.11 cents which is also above our proposed change of 3.68 cents. Additionally, we propose to increase the NFDM make by 4.67 cents and the whey make by 5.27 cents compared to USDA's scenarios of an increase of 2.15 cents on NFDM and 1.59 cents on whey.

USDA's scenarios give us an idea of how varying the cheese make allowance impacts producer prices and a bit of an idea of how changing the other makes will impact producer prices.

We would expect the impacts of AgriMark's proposal on producer milk prices to fall within the ranges estimated by the USDA. Like the USDA estimates, we would expect the impact on class prices to be the largest immediately following the changes in make allowances. In accordance with the Department's model we would expect wholesale product prices to increase and get passed along to producers through the classified pricing formulas. We would not anticipate the longer term impact of our proposed changes to far exceed the price impacts on the all milk price estimated by USDA in Scenarios 2 and 3. We also must point out that any impacts to producer blend prices by decreased Class I prices would be mitigated by the MILC program, which is not factored in the USDA analysis.

In anticipation of questions regarding Land O'Lakes financial condition, I present the following. During 2004 the Dairy Foods division of Land O'Lakes reported pretax earnings of \$16.4 million. This amount includes the operations of the cooperative's value added and industrial divisions. While Land O'Lakes has a policy of not reporting in detail of its individual plant operations, I can say that each of our butter, powder and cheese plants, included in the RCBS survey, lost money in 2004, even given the fact that the average selling or transfer price at each of the four plants was above the NASS average for the year and assuming no procurement costs were allocated to the plant. Even though the whey operation reported a profit, the cheese-whey operation reported a loss; and the favorable transfer price



between the Denmark and Greenwood plants and Kiel was very likely an important factor in Kiel's whey profitability.

### **Need for an Emergency-Expedited Decision on Updating the Cost Indices**

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

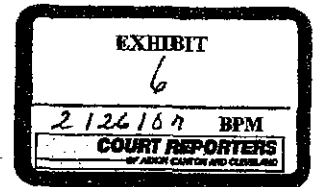
Land O'Lakes wishes to thank the Secretary and his staff for the expedited manner in which this hearing was called and look forward to a timely decision.

**Before the United States Department of  
Agriculture  
Agricultural Marketing Service**

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In the Matter of Proposed Amendments : : Docket Number  
: :  
to Tentative Marketing Agreements : : AO-14-A77, et al.  
: :  
and Orders : : DA-07-02

Testimony of Dennis J Schad  
On Behalf of Land O'Lakes, Inc



February 26, 2007

Exhibit \_\_\_\_\_

My name is Dennis Schad and I am here to testify on behalf of Land O'Lakes, Inc. My business address is 405 Park Drive, Carlisle PA. I hold a bachelors degree in History from The College of William and Mary in Virginia and a Masters in Business Administration from Virginia Tech. I have worked for Land O'Lakes and its predecessor cooperatives for twenty-five years and my current title is Director of Regulatory Affairs. Prior to this assignment, I have held positions in the cooperatives' milk procurement, marketing and transportation departments. I have testified at numerous Federal and state milk marketing order hearings and before the agriculture committees of several state legislatures.

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Land O'Lakes (LOL) is a dairy cooperative with over 3,000 dairy farmer member-owners. The cooperative has a national membership base, whose members are pooled on six different Federal orders. Land O'Lakes owns three cheese manufacturing plants and a butter/powder plant that receive federally regulated milk.

Land O'Lakes supports Proposals 1, 2, 12, 14 and 17, while opposing Proposals 3, 4, 5, 6, 7, 8, 11, 13, 15, 16, 18 and 20. At this hearing Land O'Lakes has no position on Proposals 9 and 10. I will provide evidence for several of the listed proposals and will provide argument through a written brief on others.

### **Background of Determining Class Prices**

Through the informal rulemaking process of Federal Order Reform, the Final Decision of the 2000 Class III and IV Hearing and the most recent Temporary Final Decision (TFD), USDA has developed a process to determine class prices. This process that sets Class III and IV prices replaced the M-W and Basic Formula Price Series. Theoretically Class III and IV prices are now the residual of the market price of a commodity (butter, NFDM, cheese or whey) less the cost of converting milk to that commodity.

Determining the class prices starts with the NASS price series, which describes commodity-specific products, cheddar cheese in 40 pound blocks and 500 pound barrels; butter in 25 kilogram and 68 pound boxes and NFDM and whey in "bag, tote or tanker sales." NASS reports the total price received at plants for the commodities. The manufacturing allowance is fixed; any increases to the selling price to capture increased costs are reported to NASS and all dairy farmers, regardless of whether their

marketing organization incurred the costs, benefit from the higher class prices.

The second step of the process is to determine the cost of converting milk to the commodity whose price is quoted in the NASS survey. The Department is scrupulous in making sure that commodity manufacturing costs are tied to the product described by the NASS survey. Additionally, the Department considers the factors that determine the volume of the commodity product that is processed out of a hundred pounds of milk.

The residual of this calculation represents an approximation of the value of milk used in Class III or Class IV products and is used to set Class III or IV prices. The price is designed to be the minimum regulated class price for the commodity. Additionally, USDA has defined the Class IV price to be the market clearing price and has sometimes explicitly added a component for balancing costs in the make allowance calculation.

### **Land O'Lakes Supports Proposals One and Two**

In the Temporary Final Decision (71 FR 67467) the Secretary published product price formulas for Class III and IV milk, based on a weighted average of the Cornell Price Survey and the price survey published by the California Department of Food and Agriculture (CDFA). The spirit of Proposal One is to require AMS to update the product price formulas when an input-survey to the weighted average calculation is updated or changed.

On November 29, 2006 CDFA released its Summary of Weighted Average Manufacturing Costs (Exhibit \_\_\_). These results update the CDFA manufacturing plant cost data to 2005 averages. USDA used the updated numbers to calculate the weighted averages contained in Table 4 of the Preliminary Economic Analysis, Class III and Class IV Prices.

Among the recommendations filed in Land O'Lakes' Exceptions and Comments to the Temporary Final Decision (TFD), are two that are especially relevant to Proposal One. First, Land O'Lakes recommends that the CDFA cost of manufacturing whey powder be incorporated into the USDA weighted average calculation that determines Federal order Class III prices. The TFD set the CDFA survey as the "gold standard" of manufacturing cost surveys. The Department chose to abandon the Rural Business Cooperative Service cost survey because the Cornell survey more

closely approximated the procedures of the CDFA survey. The CDFA whey powder cost survey includes three plants that aggregately manufacture 98 million pounds of whey. That volume represents 82 percent of the skim whey powder processed in California. The CDFA whey survey is a valid, audited and representative manufacturing cost study that should be included in the Class III price formula calculation.

The second recommendation was to continue the practice of weighting the CDFA and Cornell survey data by sample volume. The TFD weighted the commodity cost by the entire volume of the commodity produced in California or outside of California. For example, the result in the TFD was that the average manufacturing costs of four sampled butter plants in the Cornell survey was weighted by the volume of all of the NASS butter produced by all butter plants located outside of California, rather than the actual volume produced by the four plants. While these four sampled butter plants produced 125.6 million pounds of butter, the impact in the make allowance calculation of the costs of those four plants were weighted as if they had manufactured 995 million pounds. The weighting procedure in the TDF was neither statically valid nor reasonable.

The following Chart summarizes the butter, NFDM, cheese and whey make allowances had USDA used the sample-weighting procedures used by the 2003 Final Decision. Note that CDFA changed its sample in 2005 NFDM survey and utilized costs from nine, instead of ten plants. The impact of that CDFA procedure change is most striking in the medium cost group. For that reason, the following chart used the CDFA NFDM population cost and weight.



## Calculation of Weighted Average Cost Using 2002 Methodology

<b>Butter</b>	Volume	Wtd. Cost		<b>Cheese</b>	Volume	Wtd. Cost	
CDFA	396,628	\$ 0.1408	55,845	CDFA	826,584	\$ 0.1914	158,260
Cornell	125,600	\$ 0.1108	13,916	Cornell	963,568	\$ 0.1638	157,832
	522,228		69,762		1,792,412		314,454
			\$ 0.1336				\$ 0.1765
<b>Marketing Allowance</b>			\$ 0.0015	<b>Marketing Allowance</b>			\$ 0.0015
<b>Butter Make Allowance</b>			\$ 0.1351	<b>Cheese Make Allowance</b>			\$ 0.1780
<b>NFDM</b>	Volume	Wtd. Cost		<b>Whey</b>	Volume	Wtd. Cost	
CDFA	471,894	\$ 0.1659	78,287	CDFA	97,953	\$ 0.2851	27,926
Cornell	440,528	\$ 0.1423	62,687	Cornell	568,728	\$ 0.1941	110,390
	912,422		140,974		666,681		138,317
			\$ 0.1545				\$ 0.2075
<b>Marketing Allowance</b>			\$ 0.0015	<b>Marketing Allowance</b>			\$ 0.0015
<b>NFDM Make Allowance</b>			\$ 0.1560	<b>Dry Whey Make Allowance</b>			\$ 0.2090

**Land O'Lakes Table. Sources: Cornell Weighted Average Costs and Volumes are from TFD and CDFA Manufacturing Cost Survey (November 29, 2006).**

### Summary of Changes

	TFD	PreEcAn <sup>1</sup>	LOL
Cheese	\$.1682	\$.1711	\$.1780
Dry Whey	\$.1956	\$.1956	\$.2090
NFDM	\$.1570	\$.1662	\$.1560
Butter	\$.1202	\$.1216	\$.1351

<sup>1</sup> Preliminary Economic Analysis, USDA, AMS, February, 2007, p 8.

While LOL agrees with much of the spirit of Proposal Two, we offer specific changes to the language of the Proposal. We would like to replace the language that grants the Market Administer the authority to survey plants to an authority granted to the Director of AMS. It is important that the plant survey be national in scope. The sampled plants should be determined by a draw from a national population of plants, located outside of California. Additionally, LOL believes that the results of the national survey should be combined with the CDFA Plant Manufacturing Survey.

LOL also disagrees with section (2) of Proposal Two. We don't believe that commodity make allowances should be snubbed at the cost of the highest cost region. As class prices are determined from commodity product sales from a national market, it is consistent that make allowances be determined by the weighted average of the manufacturing costs of plants across the country. NASS breaks out the sales price of cheese between the Upper Midwest region and the remainder of the nation. Subbing the cheese make allowance at a level that covers the cost of cheese manufacture in that region opens the door to considering the regional price of cheese in determining the region's Class III price. Land O'Lakes believes the benefits of a national class price far out weigh a consideration of regional manufacturing prices in the make allowance calculation.

Land O'Lakes believes that the Secretary should conduct a manufacturing cost survey each year based on an adequate number of plants, so that a representative sample of plants is drawn. If the number of plants and the volume produced in those plants is short of the population, then valid statistical extrapolation techniques should be utilized to estimate the population averages. The Secretary should combine the survey of federal order manufacturing plants with the relevant CDFA survey.

Finally, the Secretary, like the CDFA Secretary, should clearly identify a target percentage of volume of product covered by and a target percentage of plants covered by each of the proposed make allowances. For example, the CDFA has stated, "As a general rule, the acceptable level of coverage [by the manufacturing cost (make) allowances] ranges from 50 to 80 percent of the product processed." (CDFA Panel Report, 2/20/05, pg 12) By explicitly considering the volume covered by proposed make allowances, the Secretary

will make a more informed decision and offer the industry a clearer sense of the impact of the proposed changes.

### **Land O'Lakes Opposes Proposal Three**

Proponents of Proposal Three request that the Department revise its TFD from the January 20, 2006 hearing from a weighted average of Cornell and CDFA manufacturing costs to one that includes only Cornell weighted averages. Since the 2000 Federal Order Reform Decision, the Department has, as a matter of policy, combined relevant manufacturing cost from California and plants outside of California. In the Final Decision from the 2000 Hearing, the Secretary wrote:

The use of manufacturing plant data from California plants that do not procure any of the milk that would be priced using those costs should not cause concern. The costs of manufacturing dairy products may vary slightly by region, but adoption of representative make allowances in product price formulas should not fail to use a well-documented study that includes a large amount of audited data, such as the CDFA survey. (67 FR 67915-6)

As long as the Department determines product prices from a national NASS survey that includes California commodity prices, it is appropriate for AMS to include California manufacturing costs in the make allowance determination.