STATEMENT OF ALISON L. KREBS

LEPRINO FOODS COMPANY

at the

FEDERAL MILK MARKETING ORDER HEARING

Docket No 23-J-0067; AMS-DA-23-0031

Carmel, IN

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I am Alison Krebs, Director of Dairy and Trade Policy for Leprino Foods Company (Leprino), headquartered in Denver, Colorado. As I have previously provided my full introduction in prior testimony during this hearing, that information has already been entered into the record so I will not repeat it here. In this tranche of testimony, I will address Proposals 7 through 9.

Opposition to Proposal 7, Support for Proposals 8 and 9: Manufacturing (Make) Allowances

On the proposals to update manufacturing allowances, hereinafter referred to as "make allowances," Leprino Foods strongly supports Wisconsin Cheese Makers Association ("WCMA") Proposal 8 and International Dairy Foods Association ("IDFA") Proposal 9. Related to this, Leprino Foods strongly opposes Proposal 7 from National Milk Producers Federation ("NMPF"); it is unsubstantiated and insufficient.

Across the industry it's widely agreed that make allowances are out-of-date. In fact, given the inflationary spiral of the past two years, one can safely say that make allowances are now disruptively out-of-date. I want to first clarify, for the record, how USDA (the "Department") defines a make allowance. As published in the Federal Register on both November 22, 2006, and June 20, 2008, "The make allowance factor represents the cost manufacturers incur in making raw milk into one pound of product." In other words, a make allowance is not a "cost credit" to cover a portion of these conversion costs, a make allowance is intended to represent *the* cost of converting milk into dairy products. As noted in the February 7, 2013, Final Decision from USDA: "The ability of a manufacturer to offset cost increases is limited by the level of make allowances in the Class III and Class IV price formulas." Given the current system, if manufacturing costs are not covered in their entirety, over time, the math just doesn't work. Essentially, processing assets get run into the ground and the industry lacks financial incentive for the investment needed to maintain or build sufficient processing assets.

Let me give you a view into cost of processing changes at Leprino Foods. As a historically innovative dairy processor with relatively large plants, Leprino Foods is perceived to be an efficient dairy processor. And while Leprino Foods produces mozzarella as opposed to cheddar cheese, we do manufacture two products which are included in the milk pricing formulas. We manufacture sweet whey at two plants: Allendale, Michigan and Waverly, New York. And due to the size of our footprint in Colorado, we manufacture non-fat dry milk ("NFDM") at our Greeley, Colorado plant to help balance the state's milk supply. 2022 data from all three of these plants was included in Dr. Stephenson's latest cost of processing study.

Leprino's Allendale and Waverly plants have produced sweet whey since before 2006 – when the make allowance was last updated. Our Greeley plant is newer, producing NFDM since only 2017, so the following examples on cost of processing increases will be compared to those respective years. Across our two

sweet whey plants, Leprino's Processing Non-Labor costs increased 159% between 2006 and 2022; Utilities increased 32% and Packaging grew 53%. Overall, our Total Cost, as defined in the 2022 Stephenson study, grew by 58%. With respect to NFDM, since just 2017 our Processing Non-Labor costs have skyrocketed 79% with a 67% increase in Utilities and a 69% increase in Packaging costs. These increases over just six years exceed those of the weighted industry average between the two Stephenson studies that bookend the current seventeen-year lag in updating make allowances.

As the industry is aware, despite the outdated make allowances and the recent inflationary spiral, Leprino Foods is building a new plant in Lubbock, TX. We have continued with this project because Leprino Foods believes in the long-term future of the US dairy industry, and because we want to uphold long-standing commitments to our customers. That said, this is a very difficult time to build a new plant. For example, when we run the cost of manufacturing estimate for sweet whey at this new plant, including depreciation, the cost is projected be over 80% higher than the cost of manufacturing sweet whey at the two plants where we already produce this product. Because of numbers like this, many other processors have put expansion and greenfield plant plans on hold; it is now extremely difficult for almost any new investment to cash flow. In fact, Leprino's President has said: "if make allowances aren't updated, the Lubbock plant will have to be the last plant Leprino builds in the US." With this latest bout of inflation on top of the decade-plus-long delay in updating make allowances, the economics just do not work.

Why does this matter to producers? As noted in my earlier testimony, producers need a market for their milk. Without sufficient processing capacity within a reasonable distance, dairy farms cease to be economically viable. Further suffocating dairy processors will just cascade and suffocate dairy farms. Outdated make allowances have become an unhealthy chokepoint for America's dairy industry.

Producer members of manufacturing cooperatives may already be experiencing these consequences. In addition to base-excess programs which are currently needed because milk production is being over-stimulated by the inflated regulated price, cooperative manufacturers of formula products are almost certainly incurring processing losses. This is apparent as the deficit between current make allowances and 2022 manufacturing costs for the average of low-cost processors ranges from a minimum of 10% up to 53%, depending on commodity[i]. As common banking practices require owners to absorb significant cash flow gaps, these losses are no doubt being passed on to producer milk checks either directly or indirectly. Press announcements over the past year have noted this practice.[ii] Cooperative members may see a direct deduction for manufacturing losses on their checks, or these losses are being assessed via reblending by adjusting rates, which would indirectly allocate manufacturing losses across members. So, the concern within manufacturing cooperatives that raising make allowances will reduce milk checks is outdated; adjustments are already taking place. For the long term, current make allowances are not sustainable for any entity that manufactures dairy products, regardless of ownership structure. And no reasonable banker would lend new money to a business which absolutely cannot cash flow.

NMPF's proposal states: *Raising make allowances to levels above those proposed (by NMPF) will reduce producer prices to levels that would narrow margins and negatively impact the availability of adequate supplies of milk, and thereby create disorderly marketing.*

There are multiple issues with this presumption. First, while farm level margins may initially decrease and contract milk supplies, economics 101 dictates market forces will subsequently pull farm-level prices higher to reach a new equilibrium between supply and demand. Further, margin protection programs such as Dairy Margin Coverage ("DMC") will insulate farms – particularly smaller ones – from lower margins as the market adjusts.

As to disorderly marketing, NMPF clearly misinterprets the term. Whereas tighter supplies of milk (relative to demand) will drive prices higher, "disorderly marketing" instead refers to situations where there is excess milk relative to available processing capacity within a milkshed. This occurs when milk is overpriced relative to demand, not when milk is underpriced. Said another way, disorderly marketing occurs when the price does not clear the market of the available milk volume. Typical symptoms of disorderly marketing include milk dumping and/or unusually low spot milk prices. Again, the Upper Midwest has extensively experienced both phenomena in 2023.

More accurately, lower regulated milk prices that reflect current conversion costs and tighter milk supplies would instead enhance *orderly* marketing of milk as the market moves beyond the current overpricing of milk relative to available processing capacity. If the US dairy industry wants to thrive, or even remain status quo, make allowances must be updated to competitive levels to maintain existing assets and encourage adequate investment to be made in its processing sector. And NMPF's proposal clearly states: "Subsequent analyses by NMPF and other interested parties have estimated that unit costs of inputs have subsequently risen even further above these 2018 levels" and that "average manufacturing costs… are considerably higher than the current Federal Order make allowances." This speaks to the need for significant and adequate updates to make allowances.

The NMPF proposal then goes on to note that "when manufacturing costs of commodity products exceed the established make allowances, the calculated classified prices will essentially overvalue raw milk as an input." NMPF next states that "negative impacts from outdated make allowances are unfairly borne by cooperative dairy farmers." These statements are oversimplified. Manufacturing cooperatives and proprietary processors are incurring losses while marketing cooperatives and independent producers are benefiting from the current marketplace distortion. The industry is in essence robbing Peter to pay Paul by placing the financial burden of outdated make allowances on manufacturing cooperatives and proprietary processors.

The NMPF proposal suggests that make allowances based on updated weighted average costs would assure profitability to all processors, no matter how inefficient or high cost. Of course, this presumption doesn't make sense mathematically, as a weighted average takes plant size as well as production cost into account. So, if anything, weighted averages encourage plants producing commodity products to be sized to achieve economies of scale or achieve other above average efficiencies or get left behind.

Further, the NMPF make allowance proposal is conclusory and lacks supporting data. In prior decisions, USDA has clearly noted the need for publicly available data from reputable sources to drive changes to Federal Orders.[iii] While the WCMA/IDFA proposals leverage such data from respected long-time industry economists, the NMPF proposal notes the need for "increasing make allowances from their current inadequate levels" but then states—without any evidence or data to support their position—that their proposed increases are "adequate, acceptable and reasonable".

Proposals 8 and 9 from WCMA and IDFA, respectively, offer an economically sustainable approach. First, the phase-in approach is explicitly designed to help mitigate farm-level margin shock and therefore stabilize milk supplies as the industry adjusts to long overdue make allowance updates. That said, even this phased-in approach only aims to cover 2022 costs by 2028. This is still a 6-year lag to actual costs, which may continue to limit processing investment. While this may still constrain the industry, the WCMA and IDFA proposals seek to find a best path forward.

Another reason why WCMA/IDFA proposals 8 and 9 are valid and warranted is that previous make allowance updates have been based off a similar data approach. In fact, the Final Rule for the last national hearing, published February 7, 2013, stated: "this decision finds that it is appropriate to rely on cost data

from California (CDFA survey) and the rest of the country (CPDMP survey)." As a reminder, the CPDMP survey was conducted by Dr. Mark Stephenson, author of the latest plant survey study, and Dr. Bill Schiek's estimates are built directly from CDFA data. The latest Stephenson data set is based off very robust participation, representing a majority of processing capacity and including many large manufacturers, while the Schiek estimations begin with the CDFA mandatory study data and leverage a highly accepted statistical modeling approach. Given these make allowance proposals are based on weighted average costs, the bar for remaining competitive is higher than overall average profitability.

Waiting on mandatory cost study data at this point is not a viable solution. USDA should update make allowances based on the data presented at this hearing. While various parties have suggested that make allowance updates should not be made until after mandatory cost of processing study data is available, USDA believes it does not yet have the authority to conduct such mandatory studies, and that this authority needs to be granted by Congress. (This would most likely happen in the Farm Bill.) Even if a new Farm Bill (granting this authority and funding the studies) were to move through Congress and into law this year, which is not a given due to political realities, it is unlikely that implementation of updated make allowances from mandatory cost of processing study data would take place prior to 2028. To get to that point: rulemaking, hiring and training staff, study design, study programming, training manufacturers, implementing surveys, auditing (as needed), analysis, communication of results, a hearing request, and a hearing, would all need to happen.

Despite the anticipated time lag on implementation, for the long-term health of the US dairy industry it is essential that the Department be granted this authority and routinely produce updated cost study information going forward. Otherwise, the industry will remain at odds and focused inward as opposed to seeking market opportunities that await. While Europe and New Zealand are poised to implement costly environmental regulations on their respective industries, creating a greater opportunity for the US, outdated US milk pricing regulation controls our potential and ability to grow.

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[i] Cost of Processing in Cheese, Whey, Butter and Nonfat Dry Milk Plants, Mark Stephenson, Ph.D., June 2023

[ii] Are Processing Assessments Legitimate?, by Nate Donnay. Hoard's Dairyman, October 24, 2022

[iii] USDA AMS Final Decision, February 7, 2013, https://www.regulations.gov/document/AMS-DA-07-0026-0025