

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

In the Matter of	: Docket Nos.:
	:
Milk In The Northeast	: AO- 14-A73, et al;
	:
Marketing Area, et al	: DA-03-10

**POST-HEARING BRIEF FOR DAIRY FARMERS OF AMERICA, INC.
(DFA) AND DAIRYLEA COOPERATIVE INC.**

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I. INTRODUCTION

This brief is submitted on behalf of Dairy Farmers of America, Inc. (“DFA”) and Dairylea Cooperative Inc. (“Dairylea”) It addresses proposals from this 13 day hearing which was held February 26 - March 2, in Strongsville, Ohio, April 9–13 in Indianapolis, Indiana, and July 9 – 11, 2007, in Pittsburgh, Pennsylvania, to consider proposed amendments to all federal milk marketing orders. The subject of the amendments was the formulas for the Class III and IV prices in all federal orders.

In this proceeding the Secretary must consider twenty (20) noticed proposals for amendments to the Class III and Class IV price formulas in the federal order system. The Department’s economic analysis indicates that the impact of the proposals could increase or decrease these important Class prices by more than \$.50, representing a potential “swing” in producer income, and handler minimum prices, of hundreds of millions of dollars. In this brief, DFA and Dairylea will address most of the hearing proposals, grouping them for purposes of discussion as follows: (1) proposals concerning the “yield” factors (or other algebraic multipliers or divisors) in the formulas; (2) proposals concerning the product price series in the formulas; (3) proposals concerning the make allowances, and how they are used in the formulas; and (4) other miscellaneous proposals.

This national hearing is just one of three which are currently pending before the Department and which separately, and together, will determine the price levels for all classes of milk in the federal order system. We urge the Department to address this hearing, and each of

these hearings,¹ keeping in mind the Supreme Court’s admonition in **Block v. Community Nutrition Institute**, 467 U.S. 340 (1984), that the “principal purposes [of the marketing order program] are to raise the price of agricultural products and to establish an orderly system for marketing them.” 467 U.S. at 347. In particular, dairy producers need the Department to be equally diligent in determining appropriate yield factors and related elements of the pricing formulas as in ascertaining appropriate make allowances toward the end result that there are no windfalls on either side of the producer-handler transaction and the dual objectives of ‘raising prices’ and ‘orderly’ marketing, which the Supreme Court enunciated, are accomplished.

II. OVERVIEW OF DFA’S AND DAIRYLEA’S INTERESTS AND POSITIONS

Dairy Farmers of America, Inc., (DFA) is a Capper-Volstead cooperative association of 13,500 dairy farms producing milk in forty-nine (49) states. DFA regularly markets milk on nine of the ten federal milk orders. Dairylea Cooperative Inc. is a northeast regional Capper-Volstead cooperative of 2400 dairy farmers located in seven states. Dairylea regularly markets milk on three of the ten federal milk orders. DFA and Dairylea are members of the National Milk Producers Federation (NMPF) which is the trade association voice of America’s dairy farmers, representing nearly 75% of the country’s 62,000 commercial dairy farms through their membership in NMPF’s 32 member cooperative association. DFA and Dairylea support NMPF’s collective representation of the interests of America’s dairy farmers, which involves

¹ In the ongoing interests of equity among all participants in federal orders, Dairylea and DFA urge the Department to act upon the Class I and II formula proposals in Docket No. AO-14-A76, et al, before or at the same time as the requests to change Class III and IV formulas in this hearing. For the same reason, we oppose the request made at the end of this hearing to split-out the make allowance issues for an expedited ruling.

advocating positions which attempt to balance dairy farmers' interests as producers, and, in many cases, as the owners of cooperatives which have milk manufacturing operations.

The 20 proposals in the hearing notice cover many issues and sub-issues relating to the Class III and IV price formulas in the federal orders. Our overriding request is that the Department must be even-handed in considering the needs of producers and the interests of manufacturing plants with respect to the issues in the hearing. The owners of manufacturing plants, both cooperative and proprietary, federally regulated and unregulated, are very well represented in this hearing record. DFA and DairyIea hope to add some producer perspective to some of the information and positions advocated by the plants with respect to Class III and IV prices.

Our discussion of the hearing issues is organized as follows: First, by our reckoning, Proposals 5, 6, 7, 8, 9 and 10 concern yield factors in the Class III and IV formulas. We will address these proposals first. Proposals 11, 12, 13, 14, and 15 involve price series issues and those issues will be addressed together. Issues concerning make allowances and use of them in the Class III and IV formulas are embodied in Proposals 1, 2, 3, 17, and 20 which will be discussed as a third group topic. Finally, we will comment on several other proposals, including proposals 18 and 16.

III. PROPOSALS RELATING TO YIELD FACTORS IN THE CLASS PRICE FORMULAS

A. The Butterfat Yield Factor in the Butterfat Price Applicable to all Classes Should be Revised to 1.211.

Proposal 6 submitted by Dairy Producers of New Mexico should be adopted.² The 1.20 factor should be changed to 1.211.

Ben Yale explained in detail in his testimony, Tr 1271-1279 (Exh. 32, pps.13-17), the origin and correction of what appears to have been an algebraic error in the Final Decision of 20002. Mr. Yale's calculations were not challenged by any witness. In fact, Ms. Taylor for IDFA and Leprino concurred with the Yale analysis. (Exh. 69, pps. 25-26)

The primary, perhaps only, counterpoints to adoption of proposal 6 were expressed by Ms. Taylor for IDFA and Leprino and by Mr. Schad for Land-O'Lakes. Both Ms. Taylor and Mr. Schad withheld endorsement for the proposal 6 correction unless offsetting corrections were made in the yield equations (Ms. Taylor) or make allowance (Mr. Schad). In both cases, the Department is invited to hold the incorrect yield factor in place as "security" for the changes in other formulas which the parties advocate. The Department should reject this invitation to, in essence, hold hostage an incorrect yield factor as security for changes in other elements of the formulas. Each part of the formulas should stand on its own and on its own merits.

The Proposal 6 request to change the butterfat yield factor in the formula in 7 C.F.R. §1000.50 (l) and (q) (3) from 1.20 to 1.211 should be adopted.

² Proposal 5 submitted by Dairy Farmers of America addresses the same point and proposed a substitute 1.215 factor. DFA has withdrawn proposal 5 and supports the 1.211 factor in proposal 6 as the correct number.

B. Butterfat Yield and Valuation in the Protein Price Formula

A substantial portion of the testimony at the hearing, and several proposals in the hearing notice, relate to the role and valuation of butterfat in the protein price formula. There are two primary issues: What percentage of the butterfat entering the cheese vat shall be assumed to be retained in the cheddar cheese? And what implicit value should be allowed for that portion of the butterfat which enters the cheese vat but does not end up in cheddar cheese - the so-called whey cream? The answers to both questions are imbedded in the protein price and the protein price formula. Proposals 5, 6, 8, 9, and 10 address one or both of these questions. The issues are sometimes discussed in shorthand as the “fat recovery” issue and the “whey cream value” issue. We will discuss these two issues in turn.

1. Butterfat Recovery in Cheddar Cheesemaking

The current protein price formula assumes that 90% of the butterfat **going into the cheese vat**³ is recovered in the finished cheddar cheese. This assumption is embedded in the 1.572 factor in the Class III protein price formula. The importance of the assumption is direct: the greater the fat retention in the cheese, the higher the protein value. Proposal 6 suggests that the 90% yield factor should be increased to 94%.

³ We wish to emphasize at the outset of this discussion that the fat retention calculation in the formula is based on fat going into the vat, not fat coming from the farm. Since many plants commonly calculate yields, and witnesses discuss yields, on the basis of farm tests, it is critical to specify what the source of the denominator of the retention equation is. 90% of the fat going into the vat is only 89.4% of the fat coming from the farm when the shrinkage assumptions in the current federal order formula are incorporated. Thus, as discussed in the text below, when witnesses speak of a fat retention of 90% using farm tests, it is equivalent to 90.6% of the fat going into the vat.

At the outset, it is important to note that the Department and all participants are handicapped in ascertaining complete and accurate information on cheese production yield factors such as butterfat recovery. As Mr. Sommer from the University of Wisconsin noted: there is very limited public information available on this topic for two primary reasons: plants consider the information to be proprietary, non-public data and, furthermore, many plants do not calculate accurate information with respect to butterfat recovery. (Tr. 2349). In addition, in a hearing such as this where the self-interest of the plant owners is in a lower raw milk cost, the record is not going to be well-favored with an abundance of testimony from proprietors who have higher than average yields. The information in the record needs to be viewed with these facts in mind.

There are a few other general points which we believe should be taken into consideration in determining the appropriate fat recovery percentage in the protein price formula. First, cheddar cheese production is overwhelmingly accomplished today with modern equipment and technology which enhances fat recovery. Again, Mr. Sommer testified that “80% plus” of current cheddar capacity uses modern technology capable of fat recoveries well in excess of 90%. (Tr.237) There are, of course, plants which retain cheesemaking equipment which is not up to date. For instance, Mr. Greenaway from Foremost Farms USA described that cooperative’s older equipment⁴ which, nevertheless, achieved an average fat recovery in excess of 90%. It was a recovery which he acknowledged could “be better” and with new vats “can get much higher”. (Tr.1429) Nevertheless, Foremost’s fat recovery was 90.25% on the basis of farm

⁴ There may well be financial advantages to the use of equipment which is fully depreciated and for which the plant operator has no current cost of capital, as would the owner of modern equipment. Mr. Greenaway’s financial analysis in fact tended to show that Foremost was better off with current equipment and yields than with updated equipment.

tests. This is equivalent to 90.9% under the current federal order formula which assumes that only 3.4763 lbs. of 3.5% test farm milk go into the cheese vat.⁵

The testimony of at least three cheesemakers establishes that fat retention of 92% in cheddar cheese production today is quite achievable. Mike Brown for Northwest Dairy Association testified that their fat recovery was 92%. (Exh. 23; p.7). This yield was achieved with “modern horizontal vats.” John Jennings of Great Lakes Cheese testified that their Adams, New York, plant experiences a fat retention of 91-91.5% making cheddar blocks. This is on the basis of farm weights and tests so that when adjusted for the federal order formula (see footnote 2), the recovery is approximately 92%. The Adams plant is a modest size and not a super-modern facility. The fat retention at Adams is confirmed by the volumes of whey cream which are marketed from the facility. Exhibit 51 documented those volumes of whey cream marketed to be one million pounds of fat for 2006. At the Order 1 market average test of 3.71% butterfat at the farm, the fat in the whey cream represented 6.56% of the butterfat in the farm tests. On that basis, retention in the cheese of at least 92% is indicated, even while allowing for in plant shrinkage.

The experience at Twin County Cheese, Kolonna, Iowa, as indicated by Mr. Roetlin in his testimony is quite similar to that at Great Lakes. The plant size of one million pounds per day is somewhat less than the Adams facility which averaged over one million pounds per day in 2006. However, Twin County’s marketing of 20,000 lbs. of whey cream per week indicates a fat retention in the cheddar barrel cheese of a very good level, certainly in excess of 92%. This

⁵ Sue Taylor, for IDFA and Leprino, on Exh. 69, p.14, demonstrates that the current formula assumes that for 3.5% farm test milk, 3.4763 lbs of butterfat reach the vat at which point the 90% yield is calculated. Therefore, 90.25% of $3.5 = 3.1875$ lbs of fat retained in cheese; which is 90.87% of the 3.4763 lbs assumed to enter the vat.

assumes that the whey cream is approximately 40% fat.⁶ The quality of the operation at Twin County is exemplified by Mr. Roetlin's testimony that he had only a single vat of off quality cheese since 1985. (Tr. 1463).

There is, to be sure, testimony from other witnesses that 90% recovery is as high as should be provided for in the federal order formulas and as high as can be expected from cheddar cheese production. (See, e.g., Taylor, Sommer). When evaluating the totality of the evidence of record the Department must take into account that there is never an incentive for cheese manufacturers with efficiency that is greater than the fat recovery retention rate of 90% to provide that information for the federal order hearing record. And they cannot be compelled to do so. Consequently, when evidence that does find its way to the record shows recoveries in excess of 90%, and when there is undisputed record evidence that the current cheesemaking technology makes it possible to achieve fat retention of 92% or greater, the Department should conclude that the butterfat retention factor in the Class III formula should be adjusted to realistically reflect the product value which can be obtained from a hundredweight of 3.5% producer milk.

Those on the receiving end of the price formula – dairy farmers – do not have the plant operations, first hand data, to document what fat retention is actually being experienced in the cheese industry at large. But the secondary and circumstantial information which is available to producers and their representatives is persuasive. Ben Yale's testimony with respect to this issue is quite comprehensive and discusses in detail and in depth much of the secondary information

⁶ 7,000,000 lbs of milk per week at 3.67% test would consist of more than 250,000 lbs of butterfat. 20,000 lbs of whey cream at 40% fat is 8000 lbs of fat, 3.2% of the 250,000 gross receipts, certainly indicating a retention in cheese of more than 92% of the fat.

from which he demonstrated that fat retentions of well over 90% can be inferred.

Furthermore, and as a final point, we would also urge the Secretary to consider the inference which can be drawn from the data available – or more to the point, the lack of data – with respect to marketings of whey cream. The record is replete with assertions that the marketing options for whey cream are quite limited in terms of outlets available – there are only six buyers in the entire country. And there is no published information on volumes and pricing of either whey cream or Grade B butter. If whey cream is being disposed of for Grade B butter production in the volumes suggested in testimony, the national production, just from cheddar cheese, would generate in excess of 100 million pounds of Grade B butter⁷ – and that is just from whey from cheddar production, which is about 33% of all cheese, according to NASS. So, in total, if fat is being disposed of from cheesemaking for butter-making in the volumes suggested, it would make the dairy statistics data screen (Tr. 2949).⁸ But it does not.

Viewed from a related perspective, it is significant that a concentrated cheddar cheese production area such as the state of California does not have a single in-state buyer of whey cream - the closest facility being in Utah (Tr. 2950). From this observation, one is compelled to

⁷ 2006 production of cheddar cheese was 3.124 billion lbs (Dairy Products, NASS, 2006 Annual). At 10 lbs per cwt that represents over 31 billion pounds of milk. At average (3.67%) test, that milk contains more than 1 billion lbs of butterfat. Using the proponents' assumptions of 90% retention in cheese, farm and plant shrinkage etc., 7.8% of the butterfat is recoverable as whey cream (Taylor Exh.69, p.14). 7.8% of the butterfat in 31 billion lbs of milk is a volume of just less than 90 million lbs of fat in the whey cream. This would make over 110 million lbs of Grade B (80% fat) butter.

⁸ These volumes of Grade B butter are far in excess of many product volumes reported by NASS, e.g. Pennsylvania butter production annually for 2006 as reported by NASS was 72 million lbs; New York, 16 million. Many volumes of other products less than 100 million lbs are reported, e.g., Muenster cheese, 95 million; Brick cheese, 8.6 million; dry buttermilk, 66.9 million; condensed buttermilk 93.7 million; and there are many others, all 2006 annual figures from NASS, Dairy Products, Annual Summary.

conclude that much of the whey cream initially generated in the cheddar cheesemaking process is being re-used and ultimately ends up in cheese. This potentiality was plainly acknowledged by the testimony of Ms. Taylor from Leprino who stated that they utilize 100% of their whey cream in their Italian cheeses. (Tr.2951). If whey cream was leaving cheese plants for disposal in the volumes indicated by the current federal order protein price formula, there would surely be a butter-making market for that cream in the largest milk producing and second largest cheddar cheese producing state in the country.

The record fairly supports the inference that far in excess of 90% of butterfat used in cheese production is retained in cheese.

2. Valuing Whey Cream

Proposals 9 and 10 request that the Department reduce the protein price by changing the portion of the protein price formula that credits the value of the butterfat in whey cream. The proponents request that the Department deviate from its clearly enunciated policy of pricing butterfat in all class uses at the same value (TR. 2946) to pricing a portion of the butterfat used to produce cheese at a lesser price. These proposals should not be adopted.

DFA and Dairylea do not dispute the record evidence that the butterfat in whey cream commands a lower value in the marketplace than does the butterfat in sweet cream. The price of butterfat in the Federal Order system is not established on the basis of the value of a pound of butterfat in sweet cream; as a corollary the value of the butterfat in whey cream should not be valued in that manner either. The data provided by the witness for Northwest Dairy Association illustrates this point most clearly: On a per pound of butterfat basis, the sales prices for whey cream versus sweet cream in 2005, 2006 and 2007 were:

Darigold Whey Cream Value Comparisons

Difference from Sweet Cream and FMMO Class III

Butterfat On a Per-Pound of Butterfat Basis, FOB Plant

	Whey Cream vs. Multiple	Sweet Cream Price/#	Whey Cream vs. FMMO Class III Butterfat
2005	-0.2186	-\$0.3489	-\$0.1560
2006	-0.4578	-\$0.5694	-\$0.2916
2007	-0.4045	-\$0.5031	-\$0.2857
3-Year Avg.	-0.3603	-\$0.4738	-\$0.2444

What is important is that the sweet cream price persistently exceeds the Federal Order Class III butterfat value while the whey cream price per pound is less than the Federal Order Class III butterfat value. On a three year average, the whey cream price was \$.4738 less per pound than the sweet cream price. However, the whey cream price was only \$.2444 per pound less than the Class III butterfat price. In other words, the sweet cream price per pound of butterfat was \$.23 more than the minimum Federal Order butterfat price.⁹ The Federal Order butterfat value is a minimum value based on converting the butterfat into butter. Prevailing uses for butterfat in the Federal Order system generate substantially greater than minimum order values as reflected by prevailing sweet cream prices. Whey cream prices on the other hand are on the other side of the ledger but just make up part of the total mix of the unified butterfat value throughout the class price system.

⁹ In other words, if the minimum federal order price for butterfat is \$1.50 per lb, whey cream would average \$1.2556, while sweet cream brought \$.4738 more or \$1.7294 per lb, \$.23 more than the federal order minimum Class III butterfat value.

In 2000 the Department proposed to price butterfat on a classified basis. The industry unanimously opposed the proposal. As a result of a Court decision, the Department changed its approach and reverted to pricing butterfat on a uniform basis throughout all classes of utilization. That policy was a good decision and should be adhered to. It would be inappropriate to deviate only on the low value side of butterfat usage, building the lowest value uses into the system while allowing the higher valued uses of sweet cream to be outside the Federal Order system. For these reasons, the pricing of all butterfat in Class III should be retained on the uniform basis which it presently is and proposals 9 and 10 which would deviate from that uniformity should be refused.

3. Whey cream volume

Proposal 9 also would depreciate (reduce) the Class III price by adding a novel adjustment in the formula to ostensibly account for volumes of butterfat which are neither retained in cheese nor recovered in whey cream. The Proposal in the Hearing Notice did not include the specifics of the price reduction being requested.¹⁰ Thus, the Department was not able to evaluate the economic impact of the Proposal. The hearing participants only became aware of the content of Proposal 9 when the testimony of Ms. Taylor was submitted, prior to her testifying in the final session of the hearing. At that late date and time, there was no practical opportunity for interested parties to evaluate the testimony and data and respond. Consequently, there was only one witness, the proponent, who testified on the proposal. Ms. Taylor calculates

¹⁰. The Hearing Notice said only “This proposal seeks to amend the Class III and IV product price formula by adjusting the protein price formula to reflect the lower value and reduce volume of butterfat recoverable as whey cream.” 72 Fed. Reg. At 6182 (February 9, 2007). Select Milk Producers, et al. v. Glickman. Order granting temporary injunction is at: <http://www.ams.gov/dairy/01-60.pdf>.

the impact of the “whey cream volume” adjustment requested in Proposal 9 to be \$.1145 cents per cwt on the Class III price. At roughly 50 billion pounds of Class III usage annually in the federal order system, that is more than \$50 million dollars. A deduction from producer minimum prices of such a magnitude should not be made on this minimalist record.

C. Farm to plant shrinkage

Proposal 7 advanced by Dairy Producers of New Mexico would change the Class III and IV product formulas to eliminate farm to plant shrinkage. Presently, the formulas recognize farm to plant shrinkage at .025% of all milk components and an additional .015% allowance for loss of butterfat. These allowances are built into the product yields in both the Class III and IV formulas.

The record establishes that in some production areas dominated by larger farms with farm scaling equipment, the farm to plant shrinkage built into the prior yield formulas may be excessive (Yale Exh. 32, pps. 17-24). On the other hand, the record also documents that production in many areas of the Federal Order system with lesser average farm sizes continues to have milk collection systems where the farm to plant shrinkage built into the make allowances is a reasonable approximation of average farm to plant shrinkage. (Schad TR. 2122; Exh. 56, p. 3). On this record, at the present time, DFA and Dairylea do not believe it would be prudent to amend all Federal Milk Market Orders to eliminate farm to plant shrinkage from the Class III and IV formulas.¹¹

We take this position with two caveats: First, manufacturing yield data from plant operators is commonly based upon farm weights and tests. Thus, when yields (as reported by

¹¹ As pointed out in part III A above, however, it is necessary to correct the butterfat yield factor in the formulas, the calculation of which relates to allowance for farm shrinkage.

plant operators) are based on farm weights and tests, they incorporate the farm to plant shrinkage in the yield. The current Class III and IV formulas, however, embed an explicit farm to plant shrinkage factor in the yield formulas. It is critical that as these formulas are reexamined for the correct yield factors, that farm to plant shrinkage is not “double counted.”

Second, updating the federal order system, and its price formulas, for improvements in farm and plant technology is important; and as farm to plant delivery efficiencies are experienced the federal order system should recognize such developments. The system should not simply institutionalize and license farm to plant losses in the form of the shrinkage allowance in the Class III and IV formulas.

IV. PRICE SERIES ISSUES IN THE CLASS III AND IV FORMULAS

A. The Block – barrel spread

IDFA proposal 12, which would eliminate the \$.03 per pound adjustment to barrel cheese prices in the calculation of the NASS cheddar cheese price series, should not be adopted.

The USDA Final Decision for Federal Order Reform in 1999 found: “The three cents that is added to the barrel cheese price is generally considered to be the industry standard cost difference between processing barrel cheese and processing block cheese.” 64 Fed. Reg. 16098 (1999). After extensive hearings in 2000 and 2001, that conclusion was retained in the Final Decision 67 Fed. Reg. 67906 at 67925 (November 7, 2002). The evidence noted in the 2002 Final Decision and the record in this hearing are quite similar: i.e., they include assertions by proponents of a lack of cost difference; but no substantial evidence to support the assertions. The proponents, who have the burden of proof in advocating a change to an established

regulation, did not meet the burden to set aside this USDA finding. Therefore, the \$.03 adjustment should be retained.

The only detailed data provided for this record to disprove the \$.03 figure was provided through the testimony of Jon Davis of Davisco, a major proprietary producer of barrel (and block) cheddar cheese. Mr. Davis's data, however, did not comprehensively compare his company's costs for producing barrels and blocks of cheddar cheese. To the contrary, it merely compared the "packaging and capital" cost for barrel and block production. That comparison was made on hearing Exh. 39.

There are several pertinent points to note about the information in Exh. 39: First, it only compares packaging and capital costs. These costs total about \$.03 per pound, less than 20% of the current make allowance of \$.1682 per pound of cheddar cheese. Intuitively, there is little that can be concluded about a comparison of only 20% of the costs so far as the total costs of producing blocks and barrels are concerned.¹²

Breaking it down further, we note that the packaging costs per pound of cheese for blocks are about 10% more than for barrels – \$.025740 for blocks v. \$.022926 for barrels. These costs, adjusted for moisture, reflect a packaging cost for blocks of 20% more per pound of dry matter than for barrels. The ostensible aggregate cost is only equalized by the capital and packaging costs data in this manner: The production, staging, and storage area costed for barrels was about 4 times as large as for blocks – 25,000 square feet versus 6,780 square feet. In other words, 4

¹² We recognize that Mr. Davis suggested that in their plant the costs were "essentially" the same up to the point of packaging since the same production line was used. (Tr. 1573) However, since the end products are different, in terms of moisture content at least, there must be differences in the production process and the Davisco cost data provides no basis for evaluating those production costs pre-packaging.

times the floor area for barrel production and storage was assumed to be needed for the same quantity of production. Intuitively, if one has 4 times the floor area one has more production capacity; but that was not what the Davisco data calculated. This difference in floor area was not satisfactorily explained.¹³ The equipment cost for barrels was more than 25% higher in gross numbers than for blocks. This again, just on its face, suggests greater productive capacity for the barrel side. Thus, with 4 times the floor area and 25% more equipment expense, an equal volume of cheese product (approximately 770,000,000¹⁴ lbs) was costed, with the obvious result that barrel capital cost was higher per pound than blocks, \$.0067 to \$.0051. Thus, the higher packaging costs for blocks were added to the lower building and equipment costs and the totals for blocks and barrels were found to be nearly, but not precisely, equal. This “nearly equal” result is only credible if one accepts that it takes **4 times** as much space to produce and store the same quantity of barrel cheese and block cheese. Any less disproportionate space needs would generate a proportionately lower cost for barrels — the industry–accepted assumption in the Final Decision of 2002.

Finally, the Davisco “bottom line” cost of producing barrels was less than blocks in any event, and this difference was not adjusted for the difference in moisture content of the cheeses. At Davisco’s average moisture content of 34% (Davis Tr. 1575) for barrels; and 37.75% for blocks, by its own cost analysis limited to packaging and capital, the cost per pound of cheese –

¹³ Mr. Davis suggested that the circular or oval shape of barrels requires more storage area than for blocks which could be stacked more efficiently. This may be true but in no way accounts for the need for a storage area 4 times as large – if it is for the same amount of product. The only fair inference is that the production and storage area for barrels accommodates more production, more units.

¹⁴ This is the result of dividing the total building and equipment cost for blocks and for barrels by the indicated per lb. results.

moisture adjusted — is about 10% higher for blocks. The comparable costs are calculated as follows: For blocks a cost of \$.0308 @ 37.75% (Davis Tr. 1574) moisture equals \$.0495/lb of dry matter; for barrels, the cost of \$.0296 @ 34% moisture equals \$.0448/lb of dry matter. The block cost is 10% greater per pound than the barrel cost, on a moisture adjusted basis.¹⁵

The Department should rest assured that if there was clear industry data among the NCI and IDFA membership to debunk the Final Decision's finding of the cost difference for blocks versus barrels, that information would be reflected in the record, but it is not. Partial cost information from a single cheesemaker is insufficient to support the requested change in calculation of the price series. The record does not establish a basis to change the \$.03 block barrel differential and it should remain.

Two other contentions made in support of the elimination of the 3 cent spread should be noted. First, the observation has been made by at least one witness that the use by Cornell of cost data for both blocks and barrels means that the cost differences are factored in and the price series should therefore eliminate the differential. However, the make allowance costs will continue to be block dominant. California only calculates costs for block production. This fact, in itself, represents an implied finding by CDFA that the costs are different (and no one, to our knowledge, has ever asserted that barrel production is more expensive than block production). Consequently, so long as CDFA cost data is part of the cost series it will be block-weighted.

Finally, there has been some contention that the relationship of block and barrel prices in recent months supports elimination of the \$.03 price differential. This would not be a fair use

¹⁵ The Davisco data includes no information on labor costs in packaging and storage, the implied, but undocumented assumption being that such costs are identical for blocks and barrels.

of the price series data. The relationship of the prices is reflective of supply and demand for the two products. As several witnesses observed, there has been a substantial growth in block production capacity in recent years, but little or no growth in barrel capacity. Thus, supply of blocks has dampened those prices, while the market for barrels has tightened and the prices, therefore, have strengthened. Observing the price relationships since January 2000 emphasizes the substantial volatility and swings in these prices, if anything. The weekly relationship has varied from a spread of plus \$.1234 (week of October 18–25, 2002) to a negative “spread” of \$.0915 (week of March 27– April 2, 2004). The swings in these price relationships emphasize that the prices and price-relationship are market-based, not cost-based. While the difference at the CME has averaged 3.558 cents¹⁶, roughly the same historical difference noted in the 2002 Final Decision, different averages will result from the use of different time periods, and can support almost any desired thesis. In our view, the conclusion is clear: The data respecting the price relationships does not support any inference regarding changes in the relative cost of producing the two products.

B. The influence of, and use of, CME prices.

Several proposals, including Proposals 14 and 15, address the use of Chicago Mercantile Exchange prices or price data in the Class III and IV price formulas. Proposal 14 put forward by Agri-Mark recommends incorporation of an updater formula to NASS prices in Class III (and Class I advance prices). Proposal 15 from Dairy Producers of New Mexico would use CME

¹⁶ Average of weekly CME price differences for 400 weeks from the week ending January 7, 2000 through the week ending September 7, 2007. The NASS prices average \$.013 difference for the same period.

prices for cheese, butter and nonfat dry milk powder while continuing to use NASS prices for whey powder.

Dairylea supports the use of CME prices for cheese and butter in the product price formulas. The significance of the CME prices was clearly pointed out by, among others, the witness for Saputo Cheese who testified: “Albeit not by design, the lynchpin of the US dairy industry is the Chicago Mercantile Exchange Cheddar Block Market.” (Dryer Tr. 1608) Saputo produces no cheddar cheese; but prices all its italian and specialty cheese products off the cheddar block market. (Tr. 1634–35) Saputo was not the only cheesemaker acknowledging the instrumental role of the CME prices. See also e.g., Ledman Tr. 1718-1808. The federal order system should recognize this marketplace reality and use CME prices for cheese and butter.¹⁷

Use of CME prices will address one of the issues that has been plaguing the Federal Order system since it began using product price formulas and the NASS pricing survey which is pricing circularity. If a plant attempts to pass cost of production related price increases to the marketplace, and it reports the product in the NASS survey, it increases its cost of milk. By adopting CME prices where available, this circularity is eliminated and the Federal Order prices for cheese and butter rest upon a sounder and stronger foundation. In addition, the adoption of Dairylea’s proposal 20 (discussed below) will eliminate the circularity issue for all products used to determine Class I, II, III, and IV prices. The elimination of circularity will take pressure off the constant need to have make allowance hearings since all manufacturers will be able to pass

¹⁷ The primary objection to using the CME prices rather than NASS prices is the number of transactions or observations involved. The thought is that a “thin” market such as the CME is potentially subject to manipulation. The Government Accountability Office publication, Exh. 77, considers this issue and, nevertheless recommends use of the CME. NASS prices should continue to be collected. They validate the CME values.

cost increases to the marketplace, freely and without raising their milk prices.

DFA supports use of the Agri-Mark up-dater in Proposal 14 in establishing class prices with continuation of NASS usage. The Agri-Mark proposal will make the price system significantly more efficient for both processors and producers by transmitting more efficiently the market signals of current product prices. Taking out much of the “lag” in the data collection process, it will make producer prices and processor prices in the federal order system more concurrent with the marketplace and should be adopted, if NASS prices continue to be the primary prices in the system. Some may contend that Proposal 14 should be rejected because it adds complexity to the price system. We would not disagree that all other things being equal, simpler should prevail over the complex in federal order prices. However, this proposal addresses a critical need which is to align the timing of purchase prices and sales prices for marketing margin purposes. The importance of advancing this objective is greater, in DFA’s view, than the marginal increase in complexity which Proposal 14 brings to the price formula.

V. MAKE ALLOWANCES FOR CLASS III AND IV

Although a primary hearing on make allowances for Class III and IV remains open (Docket Nos. AO-14-A74 et al), there are a number of proposals in this hearing which address the formulation of make allowances, their configuration both in terms of data and current levels, and their role in establishing Class III and IV produced prices. DFA and DairyIea urge the Department to take the following actions with respect to make allowances and related issues: (1) adopt Proposal 17 the National Milk Producer Federation energy adjuster to make allowances in all Class III and IV product formulas; (2) adopt Proposal 20, put forward by DairyIea

Cooperative, to implement a cost add-on allowance to product prices in the NASS price series; (3) retain the existing make allowances implemented under the temporary interim order in Docket No. AO-14-A74 et al; and (4) determine the price add-ons pursuant to Dairylea Proposal 20 on the basis of data in this hearing record, applying the same general methodology as used in the interim order decision presently in effect.¹⁸ We will discuss each of these recommended actions.

A. The NMPF energy cost adjuster, Proposal 17, should be adopted.

The energy cost adjuster, advanced by the National Milk Producers Federation in Proposal 17, recommends that USDA change the manufacturing cost allowances (“make allowances”) for cheddar cheese, nonfat dry milk, butter and whey by incorporating monthly energy cost adjusters in those formulas. DFA and Dairylea urge the Department to adopt this proposal.

1. The case for an energy cost adjuster in the make allowances.

There are several compelling reasons to consider an energy cost adjuster in the Class III and IV make allowances. First, energy costs are the most volatile component of manufacturing costs. Other costs tend to increase more steadily and more gradually over time and are, at least partially, offset by increased manufacturing productivity. But energy costs are different. Short-term, but often dramatic, energy price increases in recent years have often overshadowed, and at times overwhelmed, other cost and productivity changes. (Cryan, Tr. 883)

Energy prices are so volatile that a fixed energy cost component can in short order be

¹⁸ An integral piece of this class-pricing system, advocated by DFA and Dairylea, is the change to the Class I and II price formulas which are the subject of the hearing at Docket Nos. AO-14-A76, et al.

either excessive or inadequate. As Dr. Cryan testified, a fixed energy cost component “no longer makes sense.” (Cryan, Tr. 883) For example, make allowances that were based upon the extraordinarily high energy costs of late 2005 would now be clearly excessive. Since that time, natural gas prices have decreased. Because of energy cost volatility, the use of a fixed point in time estimate of energy costs in calculating make allowances can provide an unfair advantage to either dairy processors or dairy producers. When energy prices rise, fixed make allowances fail to provide adequately for plant costs; when they fall, the fixed allowance generates an unearned benefit to processors at the expense of producers.

An energy adjuster built into the make allowance formula will allow for up-to-date changes in the make allowances without a hearing. This will eliminate both the tardy response of the hearing process and the contentiousness and divisiveness which the process necessarily entails. The energy cost adjuster in Proposal 17 is a change that would be fair to all participants in the dairy industry. Indexing as part of the make allowance formula as it relates to energy will allow specific and regular price/cost adjustments - both up and down - to reflect dairy manufacturing plants’ true costs of natural gas and electricity. (Cryan, Tr. 884)

The ongoing, long-term problem of energy costs in product manufacturing cannot be effectively addressed simply by making a new point-in-time estimate and maintaining the current method of calculating make allowances. While a modest one-time adjustment could make the formulas temporarily more equitable under current conditions, subsequent changes in the energy market could quickly render a new fixed make allowance obsolete even before it is implemented. Any make allowance calculation based on a fixed-point-in-time estimate will unfairly penalize processors when energy prices go above the baseline in the revised survey, and

unfairly penalize producers when energy prices go below the baseline. Energy cost indexing makes sense and should be added to the formula.¹⁹

2. How can energy costs be regularly adjusted?

A mechanism for monthly adjustments of processors' energy costs should be based on published Producer Prices Indices, or their functional equivalent. The adjustments should be calculated from the Producer Price Indices for Industrial Natural Gas (BLS Series WPU0553, Base = Dec. 1990)²⁰ and Industrial Electric Power Distribution (BLS Series WPU0543, Base - 1982), weighted by the direct costs of electricity and fuels per pound of product, as estimated for 2004 by USDA/RBS and CDFA and for 2005 by Dr. Stephenson. (Cryan, Tr. 885)

DFA and Dairylea support the following formula as described in detail by Dr. Cryan:

*Make adjustment = [(Industrial Electricity PPI_{current}/Industrial Electricity PPI_{base}) - 1] **

*Electricity Cost_{base} + [(Industrial Natural Gas PPI_{current}/Industrial Natural Gas PPI_{base}) - 1] **

Fuel Cost_{base}.

The resulting make allowances would be equal to a base make allowance plus an energy cost adjustment. The energy costs to be indexed should be calculated from the energy elements of each cost survey in proportion to their weight in the final calculation of each base make allowance.

The objective of the formula is to adjust components of the cost of processing for each benchmark commodity, since energy is the most volatile element of processing cost. Automatic

¹⁹ **Dairylea supports no increase to make allowances other than what could result from the NMPF proposal 17.**

²⁰ The industrial natural gas PPI is superior for end-user price tracking to the PPI, # WPU0531, which tracks the price of natural gas at the wellhead or, where it is a by-product of other processing, at the processing plants.

adjustments to energy costs will cause the make allowance to more consistently reflect the costs that it is intended to reflect. The resulting make allowance will be neither too high nor too low, as energy costs swing up and down. (Tr. 886)

3. Setting the Energy Cost Base

The proposed language in Dr. Cryan's Exh. 23 is based explicitly upon USDA's economic impact analysis.²¹ That analysis developed an energy indexing calculation based upon the proposal as "presented by NMPF at the Reconvened Hearing concerning Class III and IV make allowances during the week of September 14, 2006" (Docket No. AO-14-A74), but it used the ultimate weighting of manufacturing cost data sources used in the Tentative Final Decision from that proceeding. The numbers generated by the USDA analysis generally reflect NMPF's proposal 17, as applied to the current Federal order make allowances, and given the limitations of the available data, can serve as a basis for implementing NMPF's proposal. USDA's analysis states that, "Data from the Cornell study concerning energy costs per pound have not yet been released to the public." The USDA analysis, therefore, constructs an approximation based primarily on energy costs compiled by the California Department of Food and Agriculture (CDFA). However, at the September 14 hearing, Dr. Mark Stephenson of Cornell University did present survey data regarding manufacturing costs. In his testimony he offered data on total energy costs for each of the four benchmark products, including fuel and electricity costs for each product. Exh. 24, Table 1 contains the costs from Dr. Stephenson's testimony, in addition to previously presented data on energy costs from the California Department of Food and

²¹ Exh. 7.

Agriculture and USDA's Rural Business-Cooperative Service. (Cryan Tr. 888)²²

To the extent that this proceeding leads to updated make allowance calculations, it should also produce an energy cost index adjuster with a base period value corresponding to the database time period used to produce these make allowances.

A monthly cost adjuster based upon an index is superior to any alternative updating system proposed. For instance, Proposal 2 requests an automatic updating of all make allowances based upon annual or bi-annual manufacturing cost surveys of manufacturing costs. Such surveys would tabulate electricity and fuel costs. Without indexing, even an annual make allowance revision based on annual cost data will use energy cost data up to 24 months old. Given the volatility of energy costs - not just from year to year, but from month to month - a monthly index-based update is the only way to achieve equity in milk pricing for both producers and plants. (Cryan, Tr. 889)

4. Indices to use and availability

Producers Price Indices are published by the Bureau of Labor Statistics (BLS) as a measure of changes in the prices of many factors of production. The prices for some inputs are tracked separately for residential, commercial, and industrial consumers. These Indexes are typically published monthly, in mid-month.

The Producer Price Index for Industrial Natural Gas is designated as BLS Series WPU0553 (December 1990=100). This series tracks the average price of natural gas sold by utilities to industrial customers, defined as manufacturing and mining operations. (Tr. 890)

²² Dr. Cryan, as an expert, properly relied upon data in the record of the make allowance proceeding, September 14, 2006, Tr. at pp. 133-134, and Exh. 77, p. 4, Docket No. AO-14-A74.

The Producer Price Index for Industrial Electric Power Distribution is designated as BLS Series WPU0543. Its base period is 1982; that is, the index is set equal to 100 for the annual average of 1982. This series tracks the average price of electricity sold by utilities to industrial customers, defined as manufacturing and mining operations. (Cryan, Tr. 891)

Both of these series can be retrieved from the following page in the website of the Bureau of Labor Statistics using their Series ID numbers: <http://data.bls.gov/cgi-bin/srgate>

The energy price indexes that NMPF proposes to be used are calculated each month by the Bureau of Labor Statistics. The make allowance should be made as current as possible by monthly updating. This will result in smaller, more frequent changes than if adjustments were made quarterly or annually. Just as the milk price formulas are calculated and applied each month as a formula of the dairy product prices, so should an energy cost formula be calculated and applied each month in the revised formulas.

Energy prices can, and have, varied greatly on a month-to-month basis. (Exh. 24, Figure 1) Federal order make allowances cannot effectively approximate true processing costs unless they are updated as frequently as is practicable.

5. California prices as a test series.

The only survey series of manufacturing costs over time is from California. This series provides a means of testing the fit of proposed energy cost adjustments to the make allowance. (Cryan, Tr. 891)

Exh. 24, figure 2, shows the annual California cost survey results for cheddar cheese, and nonfat dry milk, along with the make allowance for each adjusted with the electricity and natural gas adjusters proposed by NMPF in January 2006. Although the energy costs do not account for

all of the long-term changes in manufacturing costs, they do appear to clearly account for much of the year-to-year variation. (Cryan, Tr. 892)

Energy - especially natural gas - costs are a large share of the cost of processing nonfat dry milk. Cheese processing costs in California have been trending downward over 15 years. This long-term trend may or may not represent the trend nationwide. Nevertheless, the proposed make allowance adjustment does move with much of the year-to-year variation in California cheese processing costs. The graph (Exh. 24, figure 2) shows how closely an adjusted make allowance fits the change in California costs for cheese and nonfat dry milk. (Cryan, Tr. 892)

The proposed butter cost adjustment also correlates with changing costs in California butter plants, but uniquely among these plants, non-energy costs have risen considerably more than energy costs, so that it does not show up easily in a simple graph. (Tr. 892)

California whey costs were not collected before 2003. For this reason, one is unable to directly test the fit over time of our proposed energy index for whey, as one can for butter, nonfat dry milk, and cheese. However, whey drying is so similar to nonfat dry milk production that one can reasonably assume, as USDA did in order reform and the 2002 decision, that whey processing costs are similar to nonfat dry milk processing costs. The evidence for nonfat dry milk also represents evidence for whey. (Tr. 893)

Some suggest that the best way to address volatile processing costs is to establish especially large make allowances in order to cover potential cost increases. We do not agree. As the record demonstrates, aside from milk prices, energy costs are the most volatile faced by dairy product manufacturers and the only costs that tend to both rise and fall. Applying an energy cost adjuster to the make allowance avoids the need to establish an overly generous fixed

make allowance to accommodate this volatility. Allowing the make allowance to be adjusted as energy costs fluctuate accommodates both dairy processors and milk producers.

As a result, applying NMPF's proposal will tend to reduce the underlying make allowance necessary to accommodate ongoing manufacturing prices. In addition, energy price risk imposes additional costs on processors of benchmark dairy products, and reducing these risks through an energy cost adjuster will have the effect of reducing processing costs.

Proposal 17 is supported, or at least not opposed, by all or nearly all producer organizations. From the producer perspective, in particular, this proposal represents a way to provide customers with relief from the most volatile and difficult input costs of dairy product manufacturing; it gives the industry the opportunity to incorporate automatic cost adjustments in make allowances, without the expense and time consumption of the hearing process; and it builds equity into the make allowance system by recognizing that costs can go both up and down. The concern with complexity of the formulas is, we would suggest, an issue of the industry's learning curve at worst. Volatile energy costs have brought fuel surcharges or related cost/price adjustments to many products within the experience of consumers, as well as businesses. Nearly any product which is delivered has fuel or energy add-ons today, e.g. the express mail service via which this brief will be delivered. By adding an energy adjuster to make allowances, the Department will make it possible for dairy producers to pass on additional fuel and energy costs in over-order prices, a benefit to all in the industry. In an era of energy price visibility and accepted volatility, it only makes sense to have milk and dairy product pricing subject to automatic price adjustments which consumers, producers, and processors alike can readily understand.

B. Support adoption of Proposal 20 – Dairylea proposal, and no other changes to make allowances.

Proposal 20, advanced by Dairylea Cooperative, presents the Department with an opportunity to make an important advance in the federal order pricing system. By going “outside the box” (Taylor, Tr. 2501; Exh. 69, p. 29) in searching for answers to the pricing issues and challenges which vex the industry, Proposal 20 requires the most serious deliberation by the Department.

Proposal 20 will achieve a number of important objectives: It will assist dairy product manufacturers in passing their production costs on to the wholesale and retail dairy product markets (i.e., the marketplace), eliminate the pricing circularity imbedded in the NASS product price survey, create a mechanism for all dairy product manufacturers to use to assist them in passing on higher production costs, regardless of whether a manufacturer’s product is included in the NASS survey, allow for regular updates to facilitate manufacturers in passing along their production cost increases in a more timely basis, reduce and perhaps eliminate the need for future make allowance changes – which have had a divisive effect on dairy industry relationships, appease dairy farmers’ negative sentiment that Federal orders operate in a manner that facilitates manufacturers to pass their higher production costs down to producers, and provide a positive step forward in preparing the U.S. dairy product manufacturing industry for the inevitability of the real business world faced by dairy farmers and other businesses that do not have Federal assistance in mitigating higher production costs by lowering prices received by suppliers.

C. Make allowances and dairy farmer costs and perceptions.

Make allowances have become controversial to many dairy farmers. Mr. Gallagher testified that DairyIea members view the make allowance as a cost of production credit to manufacturers – financed through lower regulated milk prices. Bill Beeman, a DairyIea producer and Director, summed up the problem this way (TR. 1814):

Under the current system, manufacturers can pass their higher production costs back down to dairy farmers via make allowance changes – this system no longer works. Dairy farmers have their own production costs to deal with; we should not be burdened by taking on the costs of manufacturing plants, too. It is time for manufacturing plants to be asked to pass their higher production costs to the marketplace instead of back down to farmers.

Like dairy product manufacturers, dairy farmers face higher production costs. They too have incurred higher energy, fuel, labor, interest charges and other input costs. Recently dairy farmers have also incurred substantially higher feed costs. However, dairy farmers do not receive a regulated cost of production credit to offset these higher costs. For instance, the Federal government does not provide a cost of production credit that forces dairy input suppliers to sell their products to farmers, at a lower cost. There is not a Federal mechanism for dairy farmers to push their higher production costs back to feed dealers by forcing them to sell feed at a lower price. Instead, farmers are often encouraged to be more cost efficient or asked to negotiate higher prices in the market place to cover their higher production costs.

Producers wonder why the pricing system does not work the same way for manufacturers as it does for them. Presently, as make allowances are increased, farmers are asked to pay their own milk production cost increases as well as taking on the burden of a portion of

manufacturers' production cost increases. This is a flawed system.

D. Price circularity and The Dairy America experience

The system's price circularity is also flawed. Dairy product manufacturers operate businesses. Businesses get to choose how to mitigate rising costs through a number of management practices – including increasing their sales prices. For the vast majority of dairy products that are processed or manufactured, the option of increasing their sales price as a means of mitigating or eliminating production cost increases is a relevant option. However, if the business manufactures a product that is included in the NASS price survey, that option, partially, and, in theory completely, is unavailable. That is because the cost of production increased sales price will be picked up in the NASS price survey and ultimately will increase the price of the raw milk which was used to manufacture the dairy product. This prevents the manufacturer of NASS surveyed product from pricing its way out of a situation of rapidly rising costs of production, as a part of its business strategy.

This proposal is fashioned after the effort of milk powder manufacturers to pass along higher energy related production costs to their wholesale and retail accounts. In 2004 and 2005, Dairy America implemented energy surcharges when selling powder. The Dairy America selling price was increased by a cost add-on to the powder sales price. Their customers accepted the cost add-on and paid the powder price plus the add-on. Exhibit 53 (1) is an actual Dairy America invoice from December 2005. The line "December Surcharge" identifies a price per pound of \$.0293. This value was charged to the customer to cover the higher energy costs of producing the nonfat dry milk powder. During the product price survey process, NASS, at the request of USDA's Dairy Division, picked up the full sales price as the NASS price – the powder

price of \$.9883 plus the add-on of \$.0293. Dairy America sells a substantial portion of the U.S. powder production and almost two-thirds of U.S. powder production is included in the NASS survey. Dairy America's use of the energy surcharge effectively raised the milk price for its members and prevented them from capturing additional income to offset higher production costs – this is the circularity that Proposal 20 attempts to correct.

The Dairy America experience is not unique. In fact it is embedded in the current make allowance and price-setting system. In his testimony at the January 2006 Federal Order make allowance hearing, Dr. Robert Yonkers, for IDFA, described the challenge of the price circularity issue for the handler whose costs are \$.17 when the make allowance is \$15 as follows:

[T]he handler [with increased costs] cannot escape from its conundrum by raising its finished product prices.

....

[Assume that] before any finished product price increase, the minimum milk price was \$1.40 minus the \$0.15 [make allowance] equals \$1.25. After a finished product price increase [to cover the added costs], the minimum milk price [based on the finished product price] is \$1.42 minus 0.15 equals \$1.27. Thus, all of the money derived from the increase in the finished product price has gone directly to the farmer, in the form of a higher, legally-mandated minimum milk price. None of the money derived from the finished product price increase has gone to the handler. After paying the now higher minimum milk price, the handler only has 15 cents left over – precisely the same amount as before it raised its finished product prices.

...

Any steps [the handler] might take would be as futile as a dog chasing its own tail.²³

This circularity dynamic creates and perpetuates the need to make regulated changes to milk prices by adjusting make allowances. An alternative approach is needed - one that brings a larger measure of market orientation to the regulated pricing structure. And, one that brings

²³ Testimony of the National Cheese Institute, January 2006 Federal Milk Order Hearings, Docket NO. AO-14-A74, et al.; DA-06-01. Marked as Exh. 67.

better balance to the financial stakes surrounding make allowance changes.

E. The need to change the industry's psychology

Some of the dairy industry's best economic thinkers would say that implementation of the DairyLea proposal is unnecessary. They might comment that adjusting make allowances gets you to the same place – even if circularity exists. The theory goes that a make allowance change would eventually result in the manufacturers higher production costs being shared by both producers and marketplace via lower milk prices and higher marketplace prices. They would recognize that the initial impacts of a make allowance change would not result in an equal sharing of burden between producers and marketplace. In fact, they would say that, initially, 100 percent of the cost falls into lower producer prices. Over time, as production is impacted by lower prices, dairy product prices rise – along with producer prices – and in the end some equilibrium level is met where both producers and the marketplace are sharing the higher manufacturing costs.

USDA's economic analysis for the most recent make allowance hearing can be pointed to as empirical evidence that this process is expected to occur.²⁴ It has been widely reported that the most recent make allowance change reduces Class III prices by \$.25 per hundredweight, immediately. The USDA analysis predicts that during 2007, the impact on Class III prices would be minus \$.19 per hundredweight – suggesting that some form of supply response occurs during the first year that transfers some of the cost to the marketplace. The USDA analysis shows that by 2015, the negative impact to producer prices would be reduced to \$.08 per hundredweight. This suggests that, in the long run, the dairy farmer cost of the Class III make

²⁴ See USDA Agricultural Marketing Service (AMS), Economic Analysis, Class III and IV Make Allowances, Tentative Final Decision, November 2006.

allowance change, as it relates to Class III values, would be \$.08 and the marketplace cost would absorb \$.17.

By continuing to use USDA's analysis, it calculates that the first year's impact on milk revenues would be a reduction of \$190 - \$195 million – depending on whether the measurement in change is the All-Milk Price or is the change in Total Federal Order Cash Receipts (see Exh. 3).²⁵ We do not dispute the theory that underpins the thought process that reaches the above conclusions. In fact, we agree that the federally regulated dairy pricing world, inclusive of circularity and make allowances, works this way²⁶. However, it works this way because people have chosen to have it work this way. There is nothing that says it has to work this way.

The Federal Order program can and should work differently. The first year revenue effect should be entirely absorbed by the marketplace and that over time producer prices and revenue should decline as markets adjust to higher wholesale prices – the exact opposite progression as occurs with the current make allowance change. The elimination of the circularity issue is a necessity in pushing the first year effect off the back of dairy farmers and squarely on to the backs of those in the marketplace. Doing so would have save producers millions of dollars. USDA estimated that the current process cost producers approximately \$190 million during 2007. By changing the system to push costs up, a larger amount, and perhaps all of the \$190 million would have been absorbed by the marketplace and not producers. Over time, the end result would have been the same in price value – meaning the long run share of the cost absorption by dairy farmers would have likely been the same, but producers would have been

²⁵ *Ibid*, Table 3, page 6 and Table 11, page 15.

²⁶ Although, no one really will ever know how the \$.25 first run effect gets shared with marketplace.

financially better off getting to that equilibrium point.

A dollar is worth more today than a year from now, a fact embodied in net present value analysis.²⁷ Using USDA's analysis for the impact on producer revenue from 2007 to 2015 as a result of the make allowance changes and using an 8 percent discount rate, the net present value of the change to producer revenue is minus \$819 to \$826 million (see Exh. 53(4)).²⁸ Since the value of the production asset is determined by the future earnings potential of the asset, the net present value analysis shows that the collective production assets of the U.S. dairy farming sector were devalued by \$819 to \$826 million due to the increase in the make allowances. A large portion of the \$819+ million net present value loss could have been avoided if the process worked in the reverse order whereby the costs would be initially pushed to the marketplace. In theory, dairy producers would eventually see lower revenue as demand slowed as a result of higher marketplace prices and ultimately lowering prices to producers. However, the net decline in producer revenue would be less than the amount occurring due to the present system of adjusting make allowances.²⁹

There may be a fuzzy and gray time frame as to when and how manufacturers' costs of production get pushed up through the marketplace or down to producers. Some could argue that during the time period that manufacturers wait for a make allowance increase, it is in fact

²⁷ Net present value analysis calculates the discounted value today of an income stream received in the future.

²⁸ The calculations assume that 100% of the change in the Class I revenue is a result of the lower Class III prices and that the revenue change for Class I and Class III were combined and discounted in this analysis.

²⁹ The discussion of manufacturing costs is slicing a couple of pennies per pound pretty thinly. In reality, the marginal cost impact is so small that passing on one or two cents a pound of additional cost may not be a recognized factor in the market place and demand may not be impacted in any measurable way – meaning higher production costs could be passed on without hurting manufacturers or lowering milk prices.

pushing costs off in both directions. If so, this would suggest that no make allowance change is needed. Others could argue that manufacturers push costs entirely back to producers via lower over-order premiums – again suggesting that no make allowance change is needed. Still others could argue that manufacturers are absorbing these costs – which if so, is a problem that needs to be addressed.

However, the solution to this problem should not be one where producers' assets are devalued by over \$819+ million dollars. Instead, there needs to be change in the pricing culture and practices of the dairy industry. We recognize that in today's Federal order milk pricing regulatory environment, the leadership of USDA and Dairy Division is needed for this to occur. Dairy producers need your leadership in getting this done. The dairy manufacturing sector needs regulatory assistance in passing their higher production costs on to the marketplace. With adoption of Proposal 20, this can be accomplished.

F. How Proposal 20 works

Proposal 20 creates a mechanism for dairy manufacturers to use to help them pass their costs on to the marketplace. It will lead to a change in how people think and act and a process that has the potential to save producers millions of dollars.

In the absence of this change, or in addition to this change, the DairyLea proposal will help eliminate the pricing circularity problem from the system. Proposal 20 is a perfect complement to using CME cheese and butter prices in that it will end the circularity embedded in whey and nonfat powder prices, which will still need to use the NASS pricing survey.

USDA would determine the maximum cost add-ons and publish them on a monthly basis in their Federal Order Class III and IV price announcements. USDA would hold periodic Class

III and IV dairy products cost of production hearings – perhaps once per year.³⁰ At each hearing, it would review the make allowance calculations for cheese, whey, nonfat dry milk and butter as prescribed in the Tentative Final Decision published November 22, 2006. It would make a determination as to the cost per pound change in the make allowance values. The positive difference would become the maximum allowable cost add-on that could be excluded from NASS survey pricing for each surveyed product – cheese, whey powder, butter and nonfat dry milk.

An illustration of the calculation of the maximum allowable cost add-on is shown in Exh. 53 beginning with Table 5. (Exh. 53(5)).³¹ Exh. 53, (5)(6) and (7) are attached to this Brief as Exhibit A. These Exhibits show how DairyIdea, in Proposal 20, proposes that USDA determine the maximum allowable cost add-on for each product. Exh. 53 (6) is USDA’s calculation of the make allowances if the updated California data is used.³² This can be utilized to show the calculation of the maximum allowable cost add-on. Exh.53 (7) is a modified version of Exh. 53(6). Exh. 53(7) calculates the maximum allowable cost add-on using the updated California data. Comparing Exh. 53(6) and (7), note that the line “Scenario make allowance” in Exhibit 6 has been changed to “Target Make Allowance” in Exh. 7 and that additional lines of information

³⁰ DairyIdea would submit that this process could occur without hearing and that USDA could use the formulation as prescribed in the November 22, 2006 Tentative Decision and accompanying documentation. At the point that both the California Department of Food and Agriculture and the Cornell Program on Dairy Markets and Policy manufacturing cost of production data are updated, USDA can use the methodology to automatically recalculate the cost-of-production add-on and begin to report the new add-on.

³¹ USDA Agricultural Marketing Services (AMS), Economic Analysis, Class III and IV Make Allowances, Tentative Final Decision, November 2006, Economic Analysis Staff, Dairy Programs, Office of the Chief Economist, page 2.

³² USDA Agricultural Marketing Services (AMS), Preliminary Economic Analysis, Class III and IV Prices, February 2007, Economic Analysis Staff, Dairy Programs, Office of the Chief Economist, page 8.

have been added in Exh. 7 that are not in Exh. 6. In Exh. 7, using the cheese calculation as a reference, the cost add-on calculation utilizes the “Target Make Allowance” of \$.1711 per pound and subtracts the existing make allowance now used under the federal order program, \$.1682 per pound. This results in a value of \$.0029 per pound which is called the cost of production change. The cheese cost of production change becomes the maximum allowable cheese cost add-on under the DairyIdea proposal.

There are several examples of prices with cost add-ons which are used today. Presently, USDA publishes the Fluid Milk Promotion Order’s \$.20 assessment on Class I milk on a monthly basis when announcing Federal Order Class I prices. This process has assisted Class I handlers in passing on this cost to its customers (see Exh. 53(10)). Different but related, the Pennsylvania Milk Marketing Board has implemented a fuel adjuster to be added to Class I over-order prices under its jurisdiction. The Pennsylvania Milk Marketing Board uses the Federal Department of Energy’s, Energy Information Administration’s (EIA), publication of regional diesel fuel prices to assist in calculating the fuel surcharge that is passed on to dealers and the marketplace. Federal Orders 5 and 7 also utilize EIA information in their transportation credit programs and publish calculated information to assist the industry in determining transportation credit reimbursement. As previously indicated, Dairy America successfully implemented a cost add-on a few years ago. The point here is that Federal agencies have been assisting private entities in passing along cost factors – both by providing a mechanism to communicate the costs to the industry and by providing the information to use to determine the cost add-on.

Under Proposal 20, manufacturing plants would submit a modified Dairy Products Pricing Survey each week. Exh. 53(12) contains the existing surveys for cheese, whey, butter

and nonfat dry milk. Plants would continue to report the total dollar sales and/or dollars per pound as they presently do. These values would be inclusive of the cost add-on. The existing survey could easily be modified to identify the cost per pound and the pounds of product, or total dollars, of the regulated cost add-on that was included in any of the plant's sales. As additional information, the plant would provide copies of invoices as evidence that the cost add-on was a separately charged item and that the cost add-on does not exceed the maximum allowable value as determined by USDA for any of the product that is priced with a cost add-on. In order for the plant to receive the cost add-on credit against its sales, it would have to show on the invoices that the add-on was a separately negotiated factor, as evidenced by it being clearly indicated as such on the invoice, and that it did not exceed the maximum allowable amount. For product that is properly documented as a cost add-on, the total dollar value of the add-on on the product that was priced with the add-on will be subtracted from the total dollars of sales included in the report, to determine the plant's NASS survey price and its contribution to the weekly price calculation.

Periodically, Federal audits will be made of the reporting as part of the marketing NASS reports and audit programs. If, upon audit, it is found that a survey participant has incorrectly claimed the cost add-on, USDA will add the value back into the next weekly calculation of its product price survey. If the audit finds that the survey participant incorrectly claimed the cost add-on over a number of weeks, the values can be added to the price survey on a weekly basis by adding the total dollars of the inappropriately claimed cost add-ons and dividing by the number of weeks involved.

To facilitate correct reporting, USDA should conduct a series of visits to the plants providing the information, in advance of the implementation of the cost add-on program.

The proposed language for Proposal 20 is attached to this brief as Exh. B. It would amend section 1000.50 of all orders by adding a section (r) requiring the exclusion of the maximum cost of production add on “surcharges” from inclusion in the NASS survey prices used to calculate the class prices. It would also amend section 1000.53(a) of all orders by adding a section (12) requiring the publication of the maximum cost of production “surcharges”.

Some comments with respect to Proposal 20 expressed concerns with complexity. The Dairylea proposal is no more complex than the current procedure. Presently, costs are surveyed and hearings held, to determine updated costs of production at manufacturing plants. This same process will continue with or without the adoption of Proposal 20. Also at present, manufacturing plants provide sales data to USDA on dairy product prices which are utilized in the price formulas. This data will soon be routinely audited and there may be improved electronic methods of reporting and improved methods of data verification. All of these reporting functions and issues will continue with or without the adoption of Proposal 20. Similarly, USDA publishes monthly milk prices. Prices will continue to be published, with or without the adoption of Proposal 20, and there will continue to be new information added to the price announcements – with or without the adoption of Proposal 20.

The single change which will come with Proposal 20 will be the alteration of the price survey report so that plants can submit their cost add-ons for proper credit in the pricing survey. Certainly, a plant’s time and cost of providing this additional information and providing the necessary audit information, will be quite small and pale in comparison to the plant’s ability to retain the proceeds of the cost add-on without it influencing its raw milk price. Finally, the difficulty of manufacturers using this information as a means of passing their costs on to the marketplace is overstated, and misunderstood. Any manufacturer will immediately develop

pricing strategies to use the USDA published, government determined manufacturing cost add-ons to develop more profitable sales opportunities.

IDFA's complaint that Proposal 20 is unworkable because of the existence of non-federally regulated (California) and unregulated manufacturers is not well reasoned. If the fact of different minimum prices (or make allowances) for state order plants, and no minimum prices for non pool manufacturing plants, is a marketing problem under Proposal 20, then it is also a problem without Proposal 20. These differences in regulation³³ have existed for decades and have yet to implode the Federal Order program. These differences should not deter, impede or delay the implementation of Proposal 20. The ability of any dairy product manufacturer to sell product at a competitive advantage at any point in time is dependent on the simultaneous interaction of supply and demand conditions at a level local to the manufacturing plant and that exist on a national/international level. To suggest that the adoption of Proposal 20 would singularly place Federal Order supply plants at a disadvantage in the larger marketplace is pure hyperbole. The concerns of IDFA on this issue should be taken in the context that they are meant – to deter USDA from moving away from increasing make allowances which provide guaranteed cost reductions to both IDFA and NCI members – the processors of Class I and II products, as well as the manufacturers of Class III and IV products.

Despite the contentions of the opposition to Proposal 20, there is real-life evidence of the successful use of this program – that of Dairy America. At the time Dairy America utilized its cost add-on, it had competition from non-pool powder plants in the U.S. and around the world, yet was able to capture additional revenue through the use of an add-on.

³³ California regulation results in higher prices than under Federal Orders, from time-to-time.

Dr. Yonkers for IDFA also testified to an erroneous application of economic common sense when he suggested that a buyer of dairy products could evade the example's suggestion of a three-cent surcharge by purchasing its cheese through the Chicago Mercantile Exchange (CME). (Exh. 74, pps.2-3) The error in logic is that of IDFA. If the market price for cheese is \$1.43 (\$1.40 plus a \$.03 surcharge from a customer), why would a profit-maximizing firm provide a three-cent discount and give up the opportunity to capture an additional \$1,200 on a load of cheese? Contrary to the IDFA assertion, the CME seller is likely going to ask for a price of \$1.43 – not \$1.40.

G. Retain existing make allowances and calculate add-ons for purposes of Proposal 20

With the adoption of Proposals 17 and 20, the Department should determine the appropriate make allowances for all products and to the extent that those make allowances exceed the allowances now in effect (leaving out of the calculation the energy costs for each product), the additional cost per unit should be announced as the cost add-on allowance to be utilized pursuant to the procedures of Proposal 20. DFA and Dairylea are satisfied that the methodology employed with respect to weighting of CDFFA and Cornell data is a reasonable procedure for this purpose.

VI. OTHER ISSUES

A. State of Maine Dairy Industry Association Proposal

In proposal 18 the Maine Dairy Industry Association attempts to identify a competitive price mechanism to replace the product price formulas, make allowances, yield factors, etc., in the current Federal Order Class III and IV prices. The proposal was presented through the

testimony of Paul Christ, an eminent authority in the field. Mr. Christ presented a creative and innovative proposal for carving out competitive pay price zones within Federal Order milksheds to attempt to generate data for a new competitive pay price series.

It is probable that most participants in the industry who are now experiencing the divisiveness and difficulties of the product price formula system for determining manufacturing milk values are nostalgic for the times when the Minnesota-Wisconsin price series established those values on a competitive pay price basis. It is probable that the majority of the industry would prefer a competitive pay price if the issue were an academic one. Unfortunately, it is not.

The Maine Dairy Industry Association proposal is one which may well merit further study and, perhaps, some “pilot” type data generation. However, it is not a proposal which is ready for adoption in the Federal Order system at this time.³⁴

The Maine Dairy Industry Association and Mr. Christ certainly deserve commendation for developing a proposal which has the potential for allowing the industry in the future have a competitive pay price alternative to present product price formulas for discovering manufacturing use values.

B. National All Jersey Proposals

DFA and DairyIea support the suggestion of National All Jersey that both NASS and AMS/Dairy Market News expand their information gathering and publication relating to whey products. (See Metzger, Tr. 2525-2529).

³⁴ In addition to the need to “pilot” the price-discovery program before systemwide implementation is considered, there are practical aspects of the proposal to be resolved such as the source of “start-up” money from which to pay the 12-month rolling average PPD to the non-pooled competitive pay zone plants/producers.

There is little question that the divergence of protein values in the whey products markets has created some challenges for some cheesemakers. As Mr. Metzger testified, there are not proposals in this hearing notice³⁵, nor data available to the industry to address these issues. However, the collection and publication of additional information would be an important step forward and we urge that this suggestion be adopted. We would note that it does not require any rulemaking action for NASS or AMS/Dairy Market News to initiate data gathering surveys or publications.

³⁵ National All Jersey's proposal 16 which would re-formulate the pricing of other solids into the protein price does not address the whey valuation issue and would not in DFA and DairyLea's view add value or efficiency to the component price or class price formulas.

