

**Leprino Foods**

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FOR-1618

March 31, 1997

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United States Department of Agriculture  
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**COMMENTS RE: JANUARY 29, 1997 INVITATION FOR COMMENTS ON USE OF NATIONAL CHEESE EXCHANGE DATA IN DETERMINATION OF MILK PRICES**

Leprino Foods Company ("Leprino") manufactures and distributes mozzarella cheese to the food service and industrial sectors throughout the United States. Leprino operates seven manufacturing plants, five of which receive milk pooled through the Federal Milk Marketing Order System. Accordingly, Leprino has a vested interest in decisions made regarding the use of National Cheese Exchange ("NCE") data in connection with determining the basic formula price ("BFP"). Leprino respectfully submits these comments for consideration by the Secretary.

**OVERVIEW OF LEPRINO'S POSITION.**

The BFP within the Federal Milk Marketing Order System currently provides the basis upon which pooled milk for all uses except nonfat dry milk production is priced. As such, the BFP directly impacts the vast majority of producers, processors, and consumers throughout the United States. Given the importance of the BFP and its associated impacts on all sectors of the dairy industry, it is critical that the fundamental structure of the BFP not be altered without comprehensive and thorough review. This comprehensive review was undertaken by USDA prior to the adoption of the existing BFP in May 1995, and is again underway through the informal rule making process as part of Federal Milk Marketing Order reform. The Secretary should continue to consider any fundamental changes to the BFP within the context of the comprehensive Federal Milk Marketing Order reform process. The Secretary should not consider such changes on a piecemeal basis while the larger reform process is pending.

The NCE cheddar 40# block price, one of five commodity price series used to update the base month

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M-W to a relevant current month BFP, will most likely cease to exist by early May 1997. In its place, however, an equivalent cash market that will be associated with the Chicago Mercantile Exchange ("CME") will be established for the trading of cheddar cheese satisfying the same specifications as exist currently for cheese traded at the NCE. It is anticipated that differences in trading rules between the new cash market and the NCE will be limited to changes that will encourage a greater volume of trading, such as trading hours and anonymity. Therefore, the Secretary should use his authority under the Federal Milk Marketing Order Regulations<sup>1</sup> to adopt the cheddar 40# block price from the new cash market that will be affiliated with CME as the equivalent of the current NCE 40# block price.

The question at hand in the invitation for comments on the use of the NCE data in determining milk prices focuses on the product price updating component of the BFP calculation, rather than the broader issue of how the BFP should be established. Therefore, the following comments are confined to the updating component of the BFP. Our comments on the BFP itself will be reserved for the broader Federal Milk Marketing Order reform process.

**THE EXISTING BFP IS OPERATING AS INTENDED.**

The existing BFP continues to reflect what it was intended to reflect when implemented in May 1995: that is, supply and demand conditions for Grade B milk in Minnesota and Wisconsin. Upon consideration of numerous proposals heard during the June 1992 M-W Replacement Hearing, USDA endorsed the use of the base month M-W as the best reflection of competitive pay prices for purposes of establishing the BFP. USDA's Final Decision issued on January 27, 1995 provides, in part, that:

The degree of coordination between the current M-W price and the alternative replacements is a substantial indicator of the ability of the pricing alternatives to echo the supply and demand conditions reflected by the current M-W price... Over the three-year period, the base month M-W per hundredweight and the AgPrices M-W per hundredweight averaged nearly the same as the current M-W price per hundredweight ...  
(Final Decision at p. 13)

The product price formula updater was adopted as a mechanism to adjust the stale base month M-W to the supply and demand conditions relevant during the month to which the BFP applies. While, as expected, this updating mechanism has resulted in more rapid transmission of prices from the wholesale commodity markets to the milk price, it has not impacted the fundamental relationship between the BFP and the competitive pay prices that it is set to emulate. The existing BFP (a part of which is the product price updating mechanism) has averaged within \$0.011 per hundredweight of the base month M-W over its implementation period (May 1995 through the most recently announced base month M-W of January

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<sup>1</sup>For example, 7 CFR §1001.55 provides that "[i]f for any reason a price or pricing constituent required by this part for computing class prices or for other purposes is not available as prescribed in this part, the market administrator shall use a price or pricing constituent determined by the Secretary to be equivalent to the price or pricing constituent that is required."

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1997) in comparison with a \$.014 per hundredweight variance between the M-W and base month M-W over the immediately preceding five year period. It is clear from the simple comparison of the BFP to the base month M-W that the current formula (including the product price updater) is performing exactly as intended. That is, the existing BFP closely approximates the competitive value of grade B milk in Minnesota and Wisconsin.

One may question the merits of establishing minimum regulated prices based on competitive conditions in the highest manufacturing priced region of the country; however, that question should be dealt with as part of the broader Federal Marketing Order reform process.

#### **THE NCE CHEDDAR PRICE REMAINS AN APPROPRIATE UPDATING FACTOR.**

The NCE cheddar 40# block price continues to be an appropriate factor in the product price updater used in the BFP calculation. The NCE price is currently the most appropriate representation of supply and demand for 40# cheddar blocks in the United States. Trading on the NCE is available to a wide variety of industry participants. In its recent "Report on the National Cheese Exchange in Connection with the Application of the New York Coffee, Sugar, and Cocoa Exchange as a Contract Market Basic Formula Price", the Commodity Futures Trading Commission (CFTC) concluded that NCE membership accounts for the vast majority of the cheese handled and processed in the United States. The CFTC further noted that "the transactions appear to be a significant portion of the ten percent or so of cheese which is not committed through long term contracts and is sold on a spot basis." (Report at p. 8) Trading activity was observed to be regular and transparent and the CFTC did not indicate a cause for concern based on their review and on-site observation of the NCE.

The NCE price is embraced by the industry, by both buyers and sellers, as the prime indicator of supply and demand for the majority of cheese produced in the United States. The vast majority of cheeses, including mozzarella, are priced in reference to the weekly price at the NCE.

#### **THE SECRETARY SHOULD ADOPT CME CHEDDAR AS THE NCE PRICE EQUIVALENT.**

When the NCE discontinues trading in late April, the Secretary should adopt the 40# cheddar block from the CME as the price equivalent for purposes of the BFP calculation. It is anticipated that the cheddar cheese contract specifications on this new cash market will be substantially the same specifications as those that have been in place on the NCE. These cheese specifications have been accepted historically by the industry as accurately defining and reflecting the critical quality and performance characteristics of cheddar blocks in commercial trade. Additionally, the slight modifications in trading rules that are likely to be incorporated in the new cash market should enhance participation in the market. One change from the NCE rules likely to be incorporated into the new cash market is the conversion of trading from direct principal trading to execution through a broad network of brokers. The use of brokers is commonplace in most every other commodity market and may open participation to a broader range of industry participants. Retention of the proven cheese specifications and adoption of brokered trading should enhance trading volume from the current levels, which are already at triple the levels of the early 90's. Additionally, this new cash market will benefit by the oversight of the CME, with their extensive monitoring and other safeguarding mechanisms.

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Exchange prices have a substantial advantage over survey prices in that they are discreet prices for clearly defined product. Non-cheese issues that may affect price in commercial trade (such as special services including packaging, delivery, and financing) are clearly defined in exchange rules and remain consistent over time, thereby providing a clean and consistent price series. If the Secretary chooses a survey price of any kind as the equivalent price for the NCE in the BFP calculation, it is critical that (1) the survey is clearly and tightly defined to determine bare cheddar value (net of transportation, excessive packaging, brokerage, credit and other marketing fees, etc.); (2) participation is mandatory; and (3) the results are auditable. Any survey should reflect prices nationally with results weighted by volume.

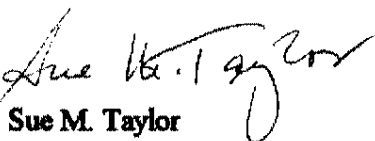
The Wisconsin Assembly points price series currently maintained by the Dairy Market News staff fails to satisfy many of these criteria. This series is currently based on a phone poll of a very small sample of upper Midwest plants. The limited scope and survey methodology should preclude the Wisconsin Assembly Points price from being considered for milk pricing purposes.

#### CONCLUSIONS.

Leprino urges the Secretary to 1) consider any fundamental changes to the determination of the BFP as part of the comprehensive Federal Milk Marketing Order reform, 2) continue the use of the NCE 40# block price as the cheese reference price in the product price updater portion of the BFP determination so long as the NCE issues a weekly opinion, and 3) declare the CME 40# block price the equivalent cheese price for purposes of calculation the BFP once the NCE price is no longer available.

Respectfully submitted March 31, 1997.

LEPRINO FOODS COMPANY



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