

Dairylea

Cooperative Inc. ♦

September 28, 2006

Mr. Gino Tosi
Associate Deputy Administrator
USDA/AMS/Dairy Programs
Order Formulation and
Enforcement Branch
Stop 0231-Room 2971
1400 Independence Avenue SW
Washington, DC 20250-0231

Dear Mr. Tosi:

Dairylea Cooperative Inc. submits the attached proposal to be included in the reopened Class III and IV hearing to consider changes to the pricing formulas. Its intent is to strengthen the Federal Order program and resolve the fractious issues surrounding circularity and the need for adjustments to make allowances. This proposal also recognizes that about 90 percent of the milk produced in the United States is manufactured or processed into products that allow rising input costs to be passed on to consumers.

Make allowances have become controversial to many dairy farmers. The Dairylea members see that manufacturers receive a cost of production credit and dairy farmers, whose production costs are also increasing due to higher energy, fuel, labor, interest charges and other input cost changes, are not receiving a cost of production credit. Farmers are often encouraged to be more cost efficient and to negotiate higher prices in the market place to cover their higher production costs. The Dairylea members and other dairy farmers are wondering why the pricing system does not work the same way for manufacturers. 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.

Just like any business, dairy product manufacturers can mitigate rising costs through a number of management practices – including increasing their sales prices. Relative to the current system of using NASS survey prices, a circularity issue does exist for those who have product included in the NASS survey and attempt to price their way out of higher production costs, as a part of their strategy. The circularity issue needs to be corrected.

Recognizing that about 10 percent of milk produced in the U.S. is manufactured into products that are included in the NASS pricing survey and have a pricing circularity issue, Dairylea members take issue that make allowance changes impact 100 percent of their milk price.

An alternative approach is needed to bring fairness and equity to all sides of the make allowance issue. In doing so, Dairylea's members prefer a process that results in production costs being passed up through the system instead of back down to them. They also recognize that Class III and IV manufacturers are valuable and important customers and that mechanisms should be implemented that assist them in passing costs through the system.

The following is an alternative approach that allows manufacturers to pass cost of production increases through the system instead of passing these costs back down to farmers. It would allow NASS price survey participants to utilize a cost of production surcharge when selling their product without the surcharge being included in the NASS price. The cost of production surcharge would be determined in a hearing and be fixed until changed via the hearing process. A NASS survey participant could utilize a surcharge up to the maximum amount established at the hearing and would have to verify that the surcharge was passed through by a separate line item charge. To facilitate manufacturers in passing their costs on relative to products excluded from the NASS price survey, the Market Administrators would publish the cost surcharge in their Class III price announcement, each month. An outline overview of this concept follows.

- Determine the per pound change in make allowances for cheese, butter, nonfat dry milk and whey powder via a Federal Order make allowance-type hearing.
 - ❖ USDA would establish "cost of production" surcharges for the four products by comparing the difference in the make allowances relative to the Federal Order hearing record and those that exist today.
 - ❖ The surcharges would not change the make allowances as they would exist at the time of the implementation of this proposal.
- The surcharges would become the maximum allowable add-on used on products sold and included in the NASS price survey.
- The add-ons would not be picked up as part of the NASS price in its survey.
 - ❖ Bills of sale would have to identify the wholesale price separately from the add-on in order for NASS to exclude the add-on in the selling price.
 - ❖ This results in the manufacturer passing on higher production costs via negotiation with the buyer and eliminates the pricing circularity issue.
- Federal Order auditors would audit these transactions to assure that there is in fact a passing along of the cost of production surcharge.

- To facilitate the process of all manufacturers passing along higher production costs, Federal Order Class Price announcements would identify the per pound cost of production surcharge for each of the four products.
- A process to regularly update the "cost of production surcharges" could be implemented.

Procedural Matters Relative to NASS Pricing and the Add-On

- NASS uses existing price survey process to collect information and calculate weekly prices.
- Each week, sales invoice records are submitted covering the prior week's sales information.
- NASS reviews the data and determines if prices were reported correctly in the survey – checking for cost plus pricing with any plus pricing not exceeding the allowed USDA "add-on".
 - ❖ If there is additional plus pricing beyond the allowed add-on, and the manufacturers surveyed price information did not include this in the base price, NASS will include the additional price increment, times the pounds of product covered, in the next occurring calculation of NASS weekly prices.
 - For example, if an entity reports cheese being sold at CME plus \$.02, and the add-on is limited to \$.01, then the dollar value of \$.01 per pound times the pounds of product such entity sold at this price, will be added to the calculation of NASS prices for the following week.
 - ❖ If NASS identifies that the survey report of prices was discounted by the allowable add-on, then such add-on was not negotiated and passed through. This will result in NASS adding the dollar value of such discount back into the calculation of the next weekly price.
 - For instance, if the plant reports a price of \$1.16 in the survey and its bill of lading shows \$1.17, then NASS will use the \$1.17 value as the NASS price and add the dollar value of one-cent per pound times the pounds of cheese covered, to the following week's price.

Alternatively a combination of NASS survey prices for whey and non fat dry milk powder and CME pricing for butter and cheese can be utilized. This would greatly reduce the survey workload and remove the concern about appropriate use of add-on pricing relative to the prices of cheese and butter.

Federal Order Class Price Announcement Addendum:

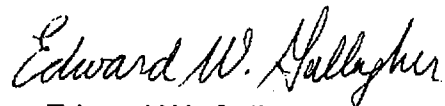
Production Cost Add-ons*	<u>Dollars</u>	
Butter	\$x.xxxx	per pound
Nonfat dry milk	\$x.xxxx	per pound
Cheese	\$x.xxxx	per pound
Dry Whey	\$x.xxxx	per pound

* Average per pound cost of production increase as determined by USDA relative to the determination of make allowances on Month, Year.

Thank you for your consideration in this matter. If you need additional information, please do not hesitate to contact me at 1-800-654-8838, extension 5658.

Dairylea Cooperative Inc. is a farmer-owned agricultural marketing and service organization with more than 2,500 member farms located throughout the Northeast. As the largest milk-marketing organization based in the region, Dairylea sells more than 5.5 billion pounds of raw milk annually through a milk-marketing network that reaches from Maine to Ohio to Maryland.

Sincerely,



Edward W. Gallagher
Vice President, Economics and
Risk Management

Attachment

Federal Order Proposal submitted by Dairylea Cooperative Inc.

Amend section 1000.50 by adding a new section as follows:

(r) Manufacturing Surcharges. For the purposes of determining the NASS survey prices for this section, as reported by the Department, cost of production add-on surcharges, up to a maximum value as contained in part (1) of this section, shall not be included in the NASS survey prices.

(1) the maximum cost of production add-on surcharges shall be as follows:

- (i) cheese \$0.0xxx per pound;
- (ii) butter \$0.0xxx per pound
- (iii) whey powder \$0.0xxx per pound, and
- (iv) nonfat dry milk \$0.0xxx per pound

(2) To be excluded from the NASS survey price, cost of production factors must be shown on the appropriate invoice as a separately negotiated surcharge to the normal price charged on the invoice, up to the maximum amount as shown for such product pursuant to part (1), above. Failure to show the add-on as such will result in any such values being included in the NASS survey price.

Amend section 1000.53 (a) by adding a new section as follows:

- (12) The rates as determined in 1000.50 (r) (1).