

**UNITED STATES DEPARTMENT OF AGRICULTURE  
BEFORE THE SECRETARY OF AGRICULTURE**

**IN RE:**

**MILK IN THE NORTHEAST AND  
OTHER MARKETING AREAS;  
Class III/IV MAKE ALLOWANCES**  
71 Fed. Reg. 545 (January 5, 2006)

**Dockets: AO-14-A74  
DA-06-01**

**POST-HEARING BRIEF OF PROPONENTS**

This post-hearing brief is submitted on behalf of Agri-Mark, Inc., Northwest Dairy Association, Foremost Farms USA Cooperative, Associated Milk Producers, Inc., and Land O'Lakes, Inc., collectively referred to as "proponents."

**STATEMENT OF THE EMERGENCY ISSUE**

What are current representative costs for milk manufacturers to convert raw milk into butter, nonfat dry milk ("NFDM"), cheddar cheese and whey powder, using methodologies established by USDA in 2002? That is the simple and limited issue before the Secretary in this proceeding. In response to this question, overwhelming and unrebutted evidence reveals that representative dairy product manufacturing costs are far greater than USDA's regulated manufacturing allowance, and that immediate amendment to the regulations is in order.

**EVENTS LEADING UP TO THE HEARING**

In September 2005, Agri-Mark submitted a request for emergency hearing, with support from other cooperative and milk manufacturing representatives, on three proposals to amend federal Class III and IV milk price formulas. (Hearing Ex. 37). One of the three proposals was accepted and incorporated in a notice of hearing published at 71 Fed. Reg. 545 (Jan. 5, 2006): "to amend [7 C.F.R.] Sec. 1000.50 milk price formulas by revising the existing manufacturing allowances for butter, nonfat dry milk, cheese, and whey powder." *Id.* at 551.

The proposal was driven by increased costs to convert milk into manufactured dairy products, including a dramatic increase in energy costs, since the hearings in which dairy product manufacturing allowances (or "make allowances") were incorporated into the current product price milk formulas, based on 1998 –1999 manufacturing cost data. These cost increases cannot be passed on to buyers due to the circular relationship between competitive product prices reported by NASS and federal Class III/IV prices. The higher costs must be

absorbed as losses by producer-members of operating cooperatives and manufacturers who thereby support artificially high milk prices benefiting other producers. Ex. 37 p. 3.<sup>1</sup> Agri-Mark members are suffering estimated losses exceeding \$ 700,000 per month in cooperative-owned manufacturing facilities due to artificially inflated Class III and IV milk prices resulting from inadequate manufacturing allowances. Wellington, Tr. I 341. The proposal under consideration will mitigate, not eliminate, these losses.

## **BACKGROUND OF REGULATORY HISTORY AND POLICY**

While the limited hearing issues build on existing methodologies for determining minimum milk prices from dairy product prices, it is useful to trace the history of product pricing in federal milk orders over the course of nearly seven decades.

Product price formulas for raw milk pricing were the norm during the first 25 years of federal milk marketing orders. As described at in General Accounting Office, *Milk pricing: New Method for Setting Farm Milk Prices Needs to Be Developed*, (GAO Nov. 1989) (<http://archive.gao.gov/d26t7/140069.pdf>), at p. 41:

Most of the orders in the early period of the milk marketing order program used a product formula in pricing milk in excess of fluid needs. Under a product price formula, the value of milk is derived by subtracting manufacturing costs and profit margins, or “make allowances.” from the price of the end products. As of December 1956, 84 percent of the orders used a product price formula as a factor for pricing milk in excess of fluid needs. As of October 1967, 19 percent of the orders used one or more product formulas for pricing milk in excess of fluid needs, and 25 percent used a product price formula in conjunction with a market-determined pay price. (These product price formulas were based primarily on butter/powder values, although some orders used a cheddar cheese formula.).

For example, the Detroit Milk Order in 1959 included a seasonally adjusted butter-powder price formula for Class II (manufactured uses) milk. The make allowance for butter was 3 cents per pound, and for NFDM was 5.5 cents per pound. 7 C.F.R. 924.50(b)(1) and (2)(1959). These rates represent 20.13 cents for butter, and 36.9 cents for NFDM, adjusted to 2005 dollars. See: <http://data.bls.gov/cgi-bin/cpicalc.pl>. As is the case today, the resulting manufacturing class price sometimes overstated milk values, leaving cooperative manufacturers and their members at a disadvantage, and requiring expedited rulemaking to

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<sup>1</sup> The impending need for a hearing to update make allowances was heralded as early as 2002, when a previous spike in energy costs spurred a suggestion for a new or reopened make allowance hearing. 67 Fed. Reg. 67909, 67940 (November 7, 2002).

correct the inequity. 24 Fed. Reg. 8116 (Oct 7, 1959); 24 Fed. Reg. 10207, 10213-14 (Dec 17, 1959)(discussing temporary reduction by 10 cents/cwt. in the seasonal Class II price).<sup>2</sup>

For the next 40 years, from the early 1960's through 1999, USDA fixed regulated milk prices on the basis of surveyed competitive prices for unregulated manufacturing grade (Grade B) milk in Minnesota and Wisconsin (M-W prices). These competitive pay prices reflected the value of milk in manufactured products and automatically captured changes in manufacturing costs to convert milk to finished products. As summarized by USDA in 1995:

When the M-W price was first adopted in 1961 as the basic formula price in the Chicago order, the Secretary determined that a competitive pay price was superior to product formulas or the support price in establishing the basic formula price. That decision states:

“The use of the competitive pay price method of pricing milk is based upon the premise that in a highly competitive economy dairy concerns will tend to purchase milk at prices commensurate with the more efficient concerns' ability to pay for the product. \*\*\*\* *Increasing labor and other costs will tend to reduce prices paid for milk.* On the other hand, the use of new assembling, processing, packaging and marketing techniques which reduce costs or increase product returns will tend to increase prices paid for milk. These *upward or downward adjustments in costs would be automatically reflected in reserve prices by using the competitive pay prices method of pricing.*”

60 Fed. Reg. 7290, 7299 (Feb. 7, 1995)(Final Basic Formula Price Decision)(emphasis added); *See also*, 64 Fed Reg. 16026, 16097 (April 2, 1999)(Under the pre-existing competitive pay price for milk, “the manufacturer’s make allowance has, in effect, been deducted from the prices received from the sale of manufactured products before the pay prices [to producers] are reported.”).

Notwithstanding the superiority of competitive pay prices for minimum price regulation purposes, in the course of Federal Milk Order Reform USDA has again returned to milk product price formulas. This was necessitated by diminished production and fewer buyers of unregulated Grade B milk. *Yonkers*, Tr. IV 359-60. The principal decisions implementing the current system of product price formulas are the Final Milk Order Reform Decision, 64 Fed Reg. 16026 (Apr 2, 1999)(“Reform Decision;” Class III and IV price discussion at pp. 16092 to 16101), and the amendments to Class III and IV price formulas published at 67 Fed. Reg. 67906 (Nov. 7, 2002)(“2002 Class III/IV decision”), following legislative and judicial directives.

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<sup>2</sup> It is noteworthy that the 1959 rulemaking to adjust the Detroit Class II price was expedited and completed within two months, with Notice of Hearing published on Aug. 31, 1959, followed by hearing, briefing, recommended decision, final decision, and rule implementation by Nov. 1, 1959.

The current product price formulas, from which Class III (milk used to produce cheddar cheese and whey powder) and Class IV (milk used to producer butter and NFDM) raw milk prices are calculated, include three primary components: (1) designation of a finished product or products for survey of the initial price reference; (2) determination and subtraction of representative manufacturing costs to convert raw milk into the finished products and byproducts, and; (3) determination of a representative yield of products and byproducts from raw milk or raw milk components to convert the per product pound milk value to a minimum skim milk and butterfat milk price. 7 C.F.R. § 1000.50(h) – (o).

Only the second component of the price formula – representative manufacturing costs – are at issue in this hearing. Although other parts of the formula may deserve attention (*e.g.*, Ex. 37, proposals 2 and 3), they are not as critical, and consideration of them would unduly complicate the simple inquiry for which this proceeding was called.

## **REGULATORY POLICIES GOVERNING CURRENT MAKE ALLOWANCES**

The 1999 Federal Milk Order Reform Decision and 2002 make allowance amendment decision preserve and emphasize several important principals, policies and inquiries governing use of make allowances in milk product price formulas of the 21<sup>st</sup> Century. These include:

- (1) The objective of a product price formula is to determine “the price handlers can afford to pay for milk... [based upon] the price for which the finished product can be sold.” Reform Decision at 16092.
- (2) The regulated product prices for Class III and IV milk “must not exceed a level that would require handlers to pay more for milk than needed to clear the market *and make a profit.*” *Id.* at 16094 – 95 (emphasis supplied).<sup>3</sup>
- (3) If make allowances are established at too low a level, manufacturers will fail to invest in plants and equipment, and reduced production capacity will result. *Id.* at 16097. “If processors are not provided enough of a manufacturing allowance to market the product they produce, or to earn any return on investment, they will not continue to provide processing capacity for producers’ milk.” 2002 Class III/IV decision at 67916; *See also*, Nourse *Report to the Secretary of Agriculture by the Federal Milk*

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<sup>3</sup> As discussed in the conclusions that follow, this standard for milk price make allowance rates is not just good policy for dairy programs. Recovery of representative costs plus a reasonable return on investment is also a mandate of federal Constitutional law where rates and economic limitations are established by regulation.

*Order Study Committee* (1962) at II-1-19 (“if surplus milk is priced too high, it may lead either to ‘homeless’ milk or place an undue burden on cooperatives to dispose of milk that handlers will not take.”).

- (4) The rate of make allowance should be representative, and “cover the costs of *most* of the processing plants that receive milk under the [federal milk] orders.” 2002 Class III/IV decision at 67915 (emphasis supplied).
- (5) It is appropriate that the rate of make allowance include a balancing cost function as reflected in average per unit product make costs due to seasonality of milk receipts and product production, and less than optimal use of plant capacity. *Id.* at 67920-21. *See also*, 70 Fed. Reg. 4931, 4951-52 (Jan. 31, 2005) (Northeast Decision, reaffirming that the 2002 Class III/IV Final Decision “gave specific recognition to costs associated with balancing in the make allowance factor in setting the Class III and Class IV milk price.”).
- (6) Competitive prices for dairy products from sources not subject to federal milk order pricing establish practical limits on handlers’ ability to increase product prices to create greater recovery of costs,<sup>4</sup> and therefore also create regulatory policy limits on the make allowance that may be adopted. “Pooled handlers must be able to compete with processors whose milk receipts are not priced in regulated markets.” 2002 Class III/IV decision at 67915.

These standards of economics, policy and law, applied to substantial evidence of record, compel immediate amendment of manufacturing allowance rates in the current milk product price formulas.

### **PROPOSED FINDINGS OF FACT**

Proponents propose the following findings and request the Secretary make a ruling on each proposed finding, and upon conclusions that follow, as required by law. 5 U.S.C. §557(c); 7 C.F.R. §§900.12(b)(2) and .13a(b).

1. The current make allowances for dairy products incorporated in USDA’s 2002 Class III/IV decision were derived primarily from 1998 manufacturing cost surveys. Since that time, by measure of the consumer price index (<http://data.bls.gov/cgi-bin/cpicalc.pl>),

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<sup>4</sup> It has become very apparent that manufacturers of cheddar cheese, butter and NFDM are unable to increase product prices to recover increased manufacturing costs. These handlers are limited not only by competition, but by the circularity of the product price formula whereby any product price increase by handlers is captured in the formula, producing a higher class price but no greater returns to cover manufacturing costs.

monetary inflation alone through 2005 would produce a 20% increase in manufacturing costs. While manufacturing plants have achieved greater efficiency in some aspects of their operations over the course of seven years, several cost inputs have increased at a rate far exceeding the general rate of dollar inflation. The evidence of record focuses on general manufacturing cost changes from 1998 through 2004, and changes in energy cost inputs from 1998 through 2005.

**A. The Nature of the Problem.**

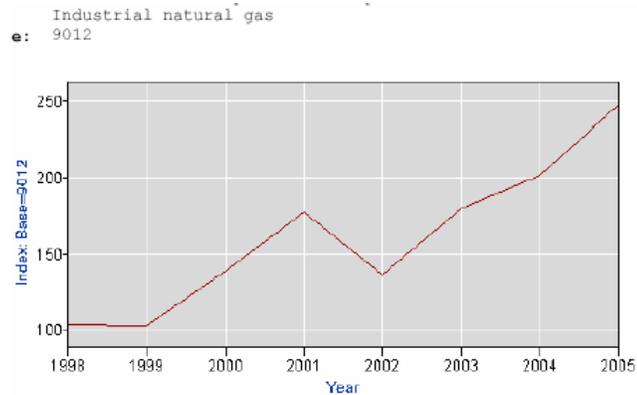
2. The return to product price formulas for classified milk price regulation in the course of federal milk order reform disabled manufacturers of butter, NFDM and cheddar cheese from effecting a competitive marketplace solution to increased manufacturing costs, as had been the practice for 40 years under M-W competitive survey pricing. The substitution of a fixed and regulated manufacturing allowance for a variable competitive allowance now precludes manufacturers from recovering increased costs through increased product prices, because the regulated price for raw milk will necessarily increase by the same amount. Under competitive pricing, this hearing would not have been necessary. Wellington Tr. II 266 – 68.

3. The futility of attempting to recover increased costs by increased prices was described by numerous witnesses as a “ratchet” effect or pricing “circularity.” The problem was illustrated on the record by the Dairy America cooperatives’ futile effort to add an energy surcharge to NFDM prices. Wellington Tr. I 305; Carlson Tr. II 314; Schad Tr. II 366 – 67; Alexander Tr. III 178; McBride, Tr. III 343; Taylor, Tr. IV 281, 285. As one witness observed: “Any steps [a plant] might take [to recover increased make costs in the marketplace] would be as futile as a dog chasing its own tail.” Yonkers, Tr. IV 316-19. Even manufacturers of dairy products not included in the NASS price surveys are limited in their ability to pass on make cost increases because of product price competition from other plants in California and unregulated areas. Gulden Tr. III 14-15; Cryan, Tr. IV 86; Dryer, Tr III 314.

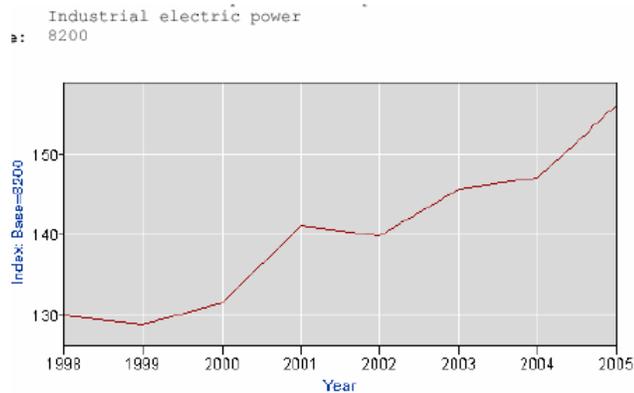
4. The significant items of input costs to make and market dairy products, which vary from product-to-product and year-to-year, include: wages and employee benefits, energy (electricity, natural gas, and fuels), packaging, chemicals and cleaning supplies, among others. Ling Exs. 18 – 20; CDFA Exs. 21 – 26; Cryan Ex. 58 (pp. 7-8). Variable and fixed costs, along with a modest return on investment, are intended to be included in make allowances. Record evidence, summarized below, reveals that typical dairy commodity manufacturers are not recovering even variable costs in the outdated make allowance, and have had to forego any recovery of fixed costs and return on investment.

5. U.S. Department of Labor, Producer Price Index and wage data for significant components of these types of cost items reveal cost increases in every category between 1998 and 2005, some below the 20% rate of inflation, some greatly exceeding the inflation rate.

(a) Industrial natural gas prices, PPI Series WPU0553, have increased by 140%.



(b) Industrial electric power prices, PPI series WPU0543, have increased by 20%.



(c) Boxes and containers prices, PPI series WPU091503, have increased by 18.6%.

(d) Specialty cleaning and sanitation product prices, PPI series WPU06720102, have increased by 8.4%

(e) Unit labor costs for non-durable goods, an index that captures improved labor productivity and efficiency, PRS32006113, have increased by 20.2%.



6. The dairy manufacturing sector revenue squeeze caused in large part by inadequate make allowances has contributed to the closing of many federal order-area manufacturing plants during recent years, loss of local manufacturing capacity, a shift of manufacturing capacity to the west, where the regulatory climate is more advantageous, a shift of remaining plant ownership from proprietors to cooperatives, and more use of local milk in Class IV products, to the disadvantage of producers and blend prices in general. Wellington, Tr. I 272-74; Carlson, Tr. II 324; McCully Tr. III 437; Ooms, Tr. IV 197; Schad, Tr. IV. 254; Yonkers, Tr. IV 319-20; Scheuerman, Tr II 331-32.

7. When local plant manufacturing capacity is lost or inadequate, milk must be transported great distances, merely to find a home for the milk, at high transportation costs charged to the producer or to all member producers of a cooperative. Wellington, Tr. II 268-671 (discussing experience in hauling Northeast milk to Western Pennsylvania, Ohio, and Wisconsin); Alexander, III Tr. 177-78; Pittman, Tr. IV 79. Added transportation costs severely reduce producer income, even if the price received for milk is at class price or more. As one opponent of Proposal 1 admitted, costs to transport milk to a distant manufacturing plant may eat up “30 to 40 percent of our milk check” when local capacity is not available. Talsma, Tr. III 241.

8. Whether due to uneconomic transportation costs or under compensated manufacturing costs, when one segment of producers bear a market cost that others do not, or bear a cost that enhances prices received by other producers, inequity between producers is created. For Agri Mark, member producers bear a 30 cent milk price deduction for manufacturing cost losses while neighbors enjoy a comparable blend price gain from the make allowance shortfall. *Compare* Wellington, Tr. I 168-70, Tr II 272-73, *with* McDowell, Ex. 2 (scenario 3 and 4). The adoption of proposal No. 1. would merely restore effective uniform prices between groups of producers.

**B. The Representative, but Conservative, 2005 cost to make cheddar cheese is at least 18.1¢ per product pound, to make butter is at least 15.4¢ per product pound, to make NFDM is at least 19.7¢ per product pound, and to make to whey powder is at least 21.6¢ per product pound.**

9. The proposed make allowance amendments are based on credible and reliable surveyed cost information for cheese, butter and NFDM in California and in non-California markets (See RBCS plant participant list, Ex. 35). The proposed whey allowance is based on California survey costs, along with compelling evidence of the amount to which whey make costs exceed NFDM make costs.

10. Seventeen plants participated in the 2004 RBCS manufacturing cost survey of non-California cheese plants. Together, these plants produced over one billion pounds of cheese, predominately cheddar. Ex. 18. This volume would represent about 45% of total cheddar cheese production of 2.2 billion pounds by 143 plants that made cheddar cheese outside of California. See NASS Dairy Products 2004 Summary report, Da 2-1 (05) at p. 22. The 2004 weighted average in-plant make costs for plants in the RBCS survey that produce 40-lb block cheddar cheese was 15.136¢ per product pound, not including administrative costs, marketing costs, or return on investment (ROI). Ling, Tr. I 131-136 (explaining omitted cost items); Ex. 18, pp. 1-2. With adjustment to account for ROI and administrative costs, the weighted average RBCS 2004 survey cost is 18¢/lb. cheese. Ex. 29, T. 4.

11. The CDFA survey of 2004 manufacturing costs at California seven American cheese plants covered 98.5% of California production, and (converted to cheddar block) reported weighted average make costs of 17.7¢/lb cheese for all plants, and 19.6¢ per pound for the group of four higher cost plants having annual average production of 47.1 million pounds of cheese per plant. Exs. 22 - 25; testimony of Krug & Reed, Tr. I. These reported costs, like RCBS surveyed costs, did not include, however, any marketing cost factor.

12. For purposes of this emergency hearing, and to produce a very conservative estimate of representative costs, proponents adopt the California weighted average cost for these plants, even though such costs from large California plants will likely fall short of USDA's stated policy objective of make allowances that "cover the costs of *most* of the processing plants that receive milk under the [federal milk] orders." 2002 Class III/IV decision at 67915 (emphasis supplied). A similar approach, as explained by proponent witnesses, is employed for other product make allowances. A more comprehensive examination of make allowances and other components of the product price formulas can be undertaken after the immediate crisis has been mitigated by an emergency rule amendment.

13. A significant factor contributing to the emergency is escalating energy costs during 2005, as explained in Agri-Mark's request for hearing. Ex. 37. These additional costs are, obviously, not captured in RBCS or CDFA surveyed costs for 2004. This component of increased costs can easily be estimated from DOE and BLS data, and should be included in an emergency amendment of make allowances, unless such inclusion will in any way materially delay implementation of an amended rule, as explained by proponents (Wellington, Tr I 330-331; Ex. 29 T. 4.), and supported by other witnesses. Cryan, Tr. IV 83-85 , 91-92, 101-115; McCully, Tr III 433-34; Yonkers, Tr IV 309.

14. A weighted average of CDFA and RBCS survey costs for cheese plants, adjusted by established factors for marketing costs, administrative costs and ROI employed by USDA in the 2002 Class III/IV make allowance decision, requires an amended make allowance of 17.94¢ to recover costs reported during 2004. An additional adjustment of 0.2¢ is justified by energy cost increases from 2004 - 2005 (Ex. 29), producing a make allowance of not less than 18.1¢/lb. cheddar cheese proposed by proponents.

15. A revised make allowance of 18.1¢ based on cost increases from 1998 to 2005 is further reinforced by detailed cost data provided by several proponent witnesses (e.g., Langworthy, Ex. 40), as well as by manufacturers that did not participate in the RCBS or CDFA surveys. For example, between 1998 and 2005, Sorrento Lactalis natural gas costs increased by 167%; its electric costs increased by 22%, its labor costs increased 46%. Notwithstanding plant closings and improved efficiencies, Lactalis cheese manufacturing costs are projected to be 30% greater in 2006 than they were in 1999. Carlson, Tr II 311-12. Foremost cheese manufacturing costs increased by 25.6% between 1999 and 2004, led by a 57% increase in employee benefits, a 64.1% increase in natural gas costs, and a 70.3% increase in electric costs. From 2004 to 2005, Foremost's cheese production costs further increased by 14.4% due in large part to energy price increases. Weis, Tr. III 49-52. Between 1998 and 2004, Davisco Foods experienced a 25% increase in labor costs, a 92% increase in employee benefit costs, a 149 increase per therm in natural gas costs, and a 14% increase in electric costs. Davis, Tr III 105-06. Between 1999 and 2005, Saputo Cheese experienced a 96% increase in electric costs, a 125% increase in natural gas costs, and a 150% increase in plastic packaging costs. Dryer, Tr III 313. In short, unrebutted and irrefutable evidence of record supports the conclusion that cheese manufacturing costs have risen significantly since 1998 - 1999, and that a modest increase in the make allowance to 18.1 cents/lb. (or more) is justified.

16. The RBCS and CDFA cost data for 2004 butter production is similar in scope and detail as for cheese, described above. Proponent's application of this data to produce a conservative make allowance of 15.4¢/lb butter, including administrative costs, marketing costs, ROI and a 2004-05 energy cost adjustment of 0.28¢/lb, is also similar. Ex. 29, table 4. Facts underlying a need for amendment are similarly unrebutted.

17. The percentage increase recommended for the butter allowance is larger than for cheese, due in significant part to erroneous understatement of the RBCS non-California plant cost data from 1998, which influenced USDA to understate costs in the allowance. Ling, Tr I

127-128; Exs. 19-20, 42; Schad Tr. II 373-78. An emergency increase of the butter make allowance is therefore needed not only to reflect current costs, but also to remedy a significant error incorporated in the current make allowance.

18. The RBCS and CDFA cost data for 2004 NFDM production is again similar in scope and detail as for cheese and butter, described above. For CDFA data, however, proponents recommend using only the medium of three costs groups in order to avoid distortion of the results by very large NFDM plants in California that are neither typical in size or function to butter-powder balancing plants in the federal order system. Proponent's application of this data produces a conservative make allowance of 19.7¢/lb NFDM, including administrative costs, marketing costs, ROI and a 2004-05 energy cost adjustment of 0.98¢/lb. Ex. 29, t. 4.

19. Facts underlying a need for an NFDM make allowance amendment are similarly unrebutted. As with the existing butter make allowance, the current NFDM allowance was influenced in significant part by a 2.75¢ understatement of the RBCS non-California plant cost data from 1998. Ling, Tr I 127-128; Exs. 19-20, 42; Schad Tr. II 373-78. An emergency increase of the NFDM make allowance is therefore needed not only to reflect current costs for typical plants in federally-regulated markets, but also to remedy a significant error and understatement of such costs in previous data on which USDA (and the industry) relied.

20. There is an extraordinary difference in costs reported in the RBCS (11.54¢/lb without administrative costs, ROI and marketing costs) and CDFA (26.7¢/lb) surveys for conversion of whey, a by-product of cheese making, into whey powder. For both CDFA and RBCS, survey of whey manufacturing costs is a recent undertaking, while cheese, butter and NFDM surveys have been conducted for many years. CDFA initiated whey manufacturing cost surveys in 2003 (Reed, Tr I 156 - 165; Exs 23, 25) ; RBCS has collected whey cost data on only one prior occasion, but the 2004 data was its first release of such data for public information.

21. The evidence reveals that one or more of the six participants in the RBCS whey survey misunderstood or overlooked instructions on what costs to include, thereby producing understated costs. E.g. McBride, Tr III 334-55, 384-85 (failed to include Tillamook's costs to condense whey to 20% solids before transportation to a West Farm whey drying plant). The evidence also reveals that the RBCS survey expressly excluded significant cost items for converting the whey by-product of cheese makers into whey powder - namely, handling,

loading and transporting liquid whey or condensed whey from a cheese plant without whey drying facilities to a plant that makes whey powder. Ling, Tr. I 135-36.<sup>5</sup>

22. Cheese makers, responding to economic signals, have come to realize that it is frequently more efficient to collect whey at a large drying facility from multiple cheese plants than for every cheese plant to invest in and operate its own whey drying or processing facility. USDA's published list entitled *Dairy plants Surveyed and Approved for USDA Grading Service*, in fact, reveals that most cheese plants do not make dry whey or other whey products. Ex. 29, table 10. This practice, and the logical need to include transportation and related costs, is confirmed by testimony of cooperative and proprietary cheese manufacturers and industry experts. McBride, Tr. III 355-56, 384-85 Ex. 52; Wellington, Tr I 307, 321-23, Tr II 235; Langworthy, Tr. II 346-47, Ex. 40 table 5; Taylor, Tr. IV 292-93, 301-305; Schad, Tr. II 382; Gulden, Tr III 33-37; Weis, Tr III 54-55; Dryer, Tr III 323-26.

23. In the absence of reliable and complete data for whey manufacturing costs, it is reasonable to follow USDA's past practice for estimating whey manufacturing costs by (1) starting with representative NFDM make costs, and (2) adding to NFDM costs the additional costs incurred to convert skim whey to whey powder. 2002 Class III/IV Decis. at 67930-31. It is un rebutted that the cost to make a pound of dry whey is greater than the cost to make a pound of NFDM. These additional costs were identified and explained in great detail by NDA's Scott Burleson, a whey manufacturing expert. Burleson, Tr . III 140 - 172; Exs. 47-48. These added costs are primarily driven by added energy to dry whey.

24. Skim milk contains about 9% solids. Skim whey contains 6% solids. By simple arithmetic, it follows that production of one pound of whey powder requires removal of 50% more water than production of a pound of NFDM. Burleson, Tr III 153. Whey must also be crystallized. The additional equipment and processing steps required for drying whey are diagrammed in Ex. 48, Chart 1. The bottom line is this: per pound of product, it costs 2.56¢ more to make whey than to make NFDM. Ex. 47 p. 5. Another manufacturer of both NFDM and whey reported almost identical results. McCully, Tr. III 435-36 (whey costs Kraft 2.6 cents per pound more to make than NFDM).

25. Proponents encourage the Secretary to add 2.5 cents to the NFDM make allowance, as supported by substantial evidence. However, for purposes of this emergency hearing, it is most important to proponents and their producer members that USDA provide prompt relief

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<sup>5</sup> The whey plants included in the RBCS survey are also very large, and are not representative of whey processing facilities in federally-regulated markets whose costs are intended to be covered by the make allowance. Taylor, Tr. IV 291 - 93.

to mitigate escalating losses. The addition of 1.9 ¢ to the proposed NFDM make allowance, producing a whey allowance of 21.6¢/lb., will satisfy this objective. Additional refinement can wait further study and hearing.

**C. The Economic Impact of Proposed Amendments and of Maintaining Status Quo on Producers, Handlers, and Adequate Supply Objectives of 7 U.S.C. §608c(18).**

26. The USDA model described by Dr. McDowell (Exs. 2, 28, 63), attempts to measure the economic impact of changing Federal Order manufacturing cost allowances on Class and producer prices and farm income. However in its attempt at modeling a very complex process, the baseline used for crucial comparison purposes did not, and likely could not, account for several key factors. The model is constrained by naïve (simple, limited and theoretical) marketplace responses to a changed make allowances. It does not measure existing income inequity between groups of producers or restored equity in projections. In fact, it does not project income at all. It projects producer prices, without regard to producer costs – such as transportation, manufacturing losses, and handling – that lower net income from prices received. It does not incorporate any market response by manufacturers to inadequate manufacturing allowance.

27. The baseline analysis is supposed to measure the economic situation if the status quo is maintained, i.e. manufacturing allowances remain unchanged from current levels. The baseline does not account for the current and future reduction in farm income for those farmers belonging to cooperatives such as Agri-Mark, Land O'Lakes, Foremost farms, Associated Milk Producers (AMPI), Michigan Milk Producers, Northwest Milk Producers, Dairy farmers of America, Dairylea and Upstate Milk producers, all of which own or have substantial investments in manufacturing facilities whose costs exceed the Federal Order make allowances. This decline in farm income should have been reduced from the baseline income reported as this income loss is clearly part of the “status quo” with no change in make allowances.

28. The baseline also does not include the impact of reduced operating margins (or losses) at all manufacturing facilities, cooperative and proprietary alike, that are currently being incurred and will continue to occur under the status quo. Such reduced margins, as described by Agri-Mark, have already resulted in losses that greatly reduce or even eliminate the ability of plants to pay over order premiums. A reduction in the over order premiums would reduce the all milk price. However such a reduction is not included in the USDA baseline.

29. The baseline also does not include the impact on farmers as plants close or receive less producer milk as their operating margins fall. In addition to the competitive loss in over order premiums from all users of milk, regardless of class, as less Federal Order milk is utilized, producer hauling costs rise as fewer local outlets for milk are available. This lowers net farm returns and negatively affects producer income. To illustrate, if the baseline provides a \$13 blend price, that price would remain constant in the model whether farm to plant transportation costs are \$0.50 or \$1.50. A projected *price* reduction of \$0.30 from the baseline does not reveal true economic impact if it preserves a \$0.50 transportation deduction from the farmer's milk check, while avoiding the 30¢ blend price reduction creates added transportation costs of \$1.00.

30. If all of these accumulated baseline omissions were accounted for in the model, the baseline income would be less and projections would account for income gains by correction of current inequities. If the baseline income were reduced, the difference between the baseline income and the various scenario incomes would also be less. Therefore the impact of the USDA model clearly overstates the impact of the make allowance changes on producer income and prices.

31. The implementation of the proposed manufacturing allowances does not cause the reduction in producer *income* imputed by the USDA model producer *price* projections. Much of the income which USDA estimates to be new price loss under its three scenarios, in reality, has already been lost to producers who operate Federal Order manufacturing plants. A significant part of the economic impact is really a restitution of income *from* farmers who are now receiving the economic benefits of higher Class and blend prices resulting from current unduly low Federal Order manufacturing allowances *to* farmers who have invested in market clearing and balancing manufacturing operations and have experienced substantial losses.

32. The average annual impact of the three scenarios considered in the hearing notice and entered into the record as Exhibit 2 ranges from a decline of 72 million to a decline of 207 million. Once again we believe these numbers to be overstated. However even the reported numbers should be kept in perspective. According to table A-1 (Baseline) of Exhibit 2, US producer revenue will average \$27.36 billion over the five-year period, for a total five year revenue of \$136.8 billion. In Table A-4 of Exhibit 2, the average annual impact over the five year period is \$207 million which cumulates to \$1.035 billion. This is a very large sum of money. However when considered as a percentage of the cumulative five year revenue expressed by the model (\$136.8 billion), the impact represents three-quarters of one percent

of the total revenue. A decrease in over order premiums or an increase in raw milk hauling costs of just \$0.10 per cwt, caused by not correcting the manufacturing allowance problem, would have a greater adverse impact on producer income than the \$0.09 reduction in average prices that may result from correction of the problem.

33. Under all scenarios, U.S. milk marketing continue to rise each year in any event. Under the baseline, U.S. marketing increase by more than 10.1 billion pounds per year during the five-year period. Under the third scenario, with the greatest producer price impact, U.S. marketings continue to increase by 9.8 billion pounds. The adequate supply objective of 7 U.S.C. §608c(18), therefore, continues to be satisfied by the proposed remedy.

### **CONCLUSIONS OF LAW AND ARGUMENT**

The hearing record contains testimony from 22 witnesses supporting Agri-Mark's proposal either directly or through the support of the National Cheese Institute. Most of these witnesses, representing major cooperative and milk manufacturing companies, also provided testimony that their dairy product manufacturing costs have increased dramatically since 1998/99 and are much higher than those provided for in current federal order manufacturing allowance provisions. The existence of manufacturing costs that exceed Federal order make allowances was never disputed on the hearing record.

#### **A. Amendment of Dairy Product Make Allowances is Compelled by Fact and Law.**

USDA's express policy that regulated make allowances should cover typical manufacturer costs and provide a reasonable return on investment is not simply a product of rational economics. It is also a product of federal Constitutional jurisprudence and statutory construction of the AMAA.

Federal regulation of milk prices is authorized to advance the "public interest," including the "interests of producers and consumers" (7 U.S.C. §§ 602, 608c(18)). By market-wide pooling of revenues, it is intended that producers will equitably share in the benefits and burdens of the milk market. *Id.* § 608c(5)(B); *Block v. Community Nutrition Institute*, 467 U.S. 340, 342 (1984), citing *Nebbia v New York*, 291 U.S. 502, 517-518 (1934). Sharing of proceeds from the sale of milk in the form of uniform producer prices is "the foundation of the statutory scheme." *Zuber v. Allen*, 396 U.S. 168, 179 (1969). *Blair v. Freeman*, 370 F.2<sup>nd</sup> 229, 237 (D.C. Cir. 1966). This objective is defeated where, as here, some producers are forced to absorb losses in the conversion of milk to dairy products, while other producers benefit in the form of artificially high Class III and IV prices from dairy

product revenue that should, but cannot, be used by manufacturers to cover average manufacturing costs plus a reasonable return on investment.

Dairy product manufacturers cannot be required, in order to support the government's obligation of furthering the public interest or the perceived best interests of the dairy industry, to bear alone the burden of artificially high Class III and IV milk prices and losses produced by inadequate make allowances. The Fifth Amendment forbids the taking of private property for public use without just compensation. This applies to physical taking of land and other property, as well as "regulatory takings" that limit or foreclose investment-backed expectations in business. The Supreme Court has recognized that this constitutional guarantee is "designed to bar Government from forcing some people alone to bear public burdens which, in all fairness and justice, should be borne by the public as a whole." *Penn Central Transp. Co. v New York City*, 438 U. S. 104, 123-124 (1978) (quoting *Armstrong v. United States*, 364 U.S. 40, 49 (1960)).

The potential Constitutional infirmity of confiscatory economic regulation may be avoided by rules that, by any reasonable methodology, result in rates and limitations that allow regulated entities to retain enough revenue to recover operating expenses, capital costs, plus a fair return on investment. *Federal Power Commission v. Hope Natural Gas Co.*, 320 U.S. 591(1944).<sup>6</sup> That is essentially the standard employed for make allowance methodology by the Secretary in the 1999 Reform Decision and the 2002 Class III/IV decision amending dairy product make allowances. There is, therefore, no occasion to reinvent the wheel. Some of the spokes need to be adjusted, however, so that the make allowance will continue to conform to USDA policy, the AMAA, and the Constitution.

That dairy product manufacturing costs have increased substantially since 1998 is un rebutted. It is therefore necessary to increase make allowances to reestablish recovery of reasonable costs plus a modest return on investment for representative manufacturing plants. On the basis of overwhelming (not merely substantial) record evidence of average

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<sup>6</sup> The flexible standards for economic rules that conform to the 5<sup>th</sup> Amendment, expressed in the landmark case of *Hope Natural Gas*, have been consistently applied for over six decades. See: *Verizon Communications, Inc., v. FCC*, 535 U.S. 467 (2002); *Duquesne Light Co. v. Barasch*, 488 U.S. 299, 310 (1989), *Permian Basin Area Rate Cases*, 390 U.S. 747, 790-91 (1968); *Michigan Bell Telephone Co v. Engler*, 257 F3d 587 (6th Cir.2001). If an otherwise lawful rule results in a regulatory taking under these standards, the 5<sup>th</sup> amendment is satisfied by compensation to the regulated party for the lost value of property. *Lingle v. Chevron U.S.A. Inc.*, 125 S.Ct. 2074 (2005); *Preseault v. ICC*, 494 U.S. 1 (1990); *Cienega Gardens v. United States*, 331 F.3d 1319 (Fed. Cir. 2003); *Lion Raisins, Inc. v. United States*, 416 F.3d 1356 (Fed. Cir. 2005).

manufacturing costs during 2004, plus the additional cost per product pound attributable solely to energy cost increases during 2005, the Section 1000.50 make allowance for cheese should be increased from 16.5¢ per pound to not less than 18.1¢ per pound; the make allowance for dry whey should be increased from 15.9¢ per pound to not less than 21.6¢ per pound; the make allowance for butter should be increased from 11.5¢ per pound to not less than 15.4¢ per pound; and the make allowance for NFDM should be increased from 14¢ per pound to not less than 19.7¢ per pound.

**B. Expedited and Emergency Implementation of Amendments is Imperative and Unavoidable.**

The Administrative Procedure Act and USDA's Rules of Practice allow a final or interim decision to be made effective without a recommended decision if the Secretary "finds on the record that due and timely execution of its functions imperatively and unavoidably so requires." 5 U.S.C. § 557(b)(2); 7 C.F.R. 900.12(d). This is clearly a proceeding where timely rule amendments are imperative and unavoidable, consistent with many other emergency milk order decisions in the past.

In a recent Decision and Order relying on this authority, USDA implemented transportation credits two months after hearing to compensate cooperatives and other handlers for extraordinary costs arising after hurricanes disrupted production and distribution of milk in the southeast. 69 Fed. Reg. 71697 (Dec. 10, 2004).<sup>7</sup> The make allowances at issue in this hearing are even more critical to reestablish equity between producers and to mitigate future losses to the manufacturing segment of the regulated industry. Because the make allowances adopted in 2002 were largely based on 1998 data, they were already outdated when put into effect. The storm has been gathering since, fueled by hurricane-driven and sharply escalating energy costs during the last half of 2005.

Each month that passes without relief, Class III and IV manufacturers are contributing at least \$ 26 million, on average, to the federal order milk pools that should be used to cover manufacturing costs, and would have been so used if milk prices were still regulated on the

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<sup>7</sup> Other examples of federal milk order expedited and emergency rulemaking include: 33 FR 6016 (April 19, 1968)(Final decision for national 20¢ Class I surcharge issued 2 months after hearing, with intervening recommended decision); 47 FR 17530 (April 23, 1982) (Final emergency decision issued 5 weeks after hearing for surplus milk credits in 6 southeast markets); 49 FR 34028 (Aug 28, 1984)(Final emergency decision issued 21 days after hearing for Class I transportation credits and surcharge in 14 southeast markets). Dairy Program's sister agency in California ordinarily issues state milk order decisions within sixty days after hearing, including consideration of post-hearing briefs and recommendations of a staff hearing panel. Kelly Krug, Tr. 204-205, 210.

basis of surveyed competitive prices.<sup>8</sup> These contributions, while creating losses for manufacturers, operating cooperatives and their members, have artificially enhanced blend prices and milk revenues to pool producers that do not share in the manufacturing losses. Plants located in federal order markets have closed in recent years because of the disconnect between milk product revenue and regulated milk prices. Other plants continue to operate at a real loss hoping for relief. Waiting for more plants to close, or to relocate manufacturing capacity to California, before an emergency is declared will be too late. Their obituary will read: “I told you I was sick..” (Wellington-Yonkers colloquy, Tr. IV 362-63). The emergency remedy sought in this case may be sufficient, though barely, to keep the patient in intensive care pending more thorough economic study and hearing on broader Class III/IV product pricing formulas in the near future.

Immediate relief prior to the months of greatest surplus milk production in the spring is required to mitigate further erosion of manufacturing capacity for the benefit of all producers, to restore equitable sharing among all producers of the benefits and burdens of classified pricing, and to restore equity between handlers.

### **C. Comments on Opposition Testimony and Arguments Advanced at the Hearing.**

#### **1. The notion that dairy product manufacturers should be required to operate without recovery of manufacturing costs, or may pass on increased costs to product purchasers.**

Some producer witnesses asserted that make allowances should not be included in regulated prices at all, or that manufacturers should recover make cost increases from buyers of manufactured dairy products. Tewksbury, Tr II 16; Hall, Tr. II 37; Cochran, Tr. II 79. This testimony reveals only that the industry needs to do a better job in educating producers on how regulated prices work and have worked.

The current product price formula make allowance functions in a similar way to margins between product prices and producer prices under the former M-W competitive price formula. The primary difference is that the make allowance is now red-flagged as a line item in the price formula, creating the erroneous perception that it is a new cost borne by producers, and the rigidity of regulated make allowances creates higher class III and IV

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<sup>8</sup> Monthly average contribution of lost manufacturing allowance to the federal order pools is calculated by multiplying proposed Class III and IV price changes (Ex. 29 table 7) by Class III and IV utilization of producer Milk. FMOS Annual 2005, tables 21 and 22. On a monthly basis, such contributions reached their peak (\$33 million) in May 2005, and will again be disproportionately larger during the spring 2006 flush unless prompt amendments are effected.

prices, to the benefit of many producers, when cost increases would have produced a lower farm price under the M-W system.

The producers' perception that handlers should be able to recover increased costs from dairy product buyers reveals a lack of understanding of the complex way in which pricing circularity precludes such recovery.

**2. The notion that the Secretary's authority may be limited by private, long-term contracts.**

A group of very large southwest producers (Select, Zia and Lone Star), with herd averages of 2,000 cows (Talsma, Tr. III 224, 238, 246), objected to the proposal on grounds that they were obligated by a long term contract to supply a new cheese plant "based on" the Class III price. *Id.* Tr. III 216. The contract was made in late 2003 before construction of the plant began. *Id.* 232. Clearly, Select or its negotiating representatives, knew when the contract was signed that dairy product make costs are variable, and that federal order make allowances were subject to change in the future as they had been changed several times under CDFR rules. *Id.* 232-36. The witness also acknowledged that his perceived blend price loss under proposal No. 1 would be partially offset by increased income based on the cooperatives' share of ownership in the new cheese plant, and refused to reveal on "confidential" ground other terms of the contract, including whether there was a regulatory action escape clause. *Id.* 247-48, 253

Participants in a regulated or competitive market assume risks of changes in competition or changes in market conditions when they enter into contracts. Select's supply contracts are totally irrelevant to the question of whether make costs have increased or whether it is in the interest of the dairy industry as whole to adjust regulations to accommodate these increases.

**3. The notion that the Secretary may not consider "make allowances," or provide make allowance relief, unless other components of the pricing formula are also put on the hearing table.**

Counsel for Select Milk Producers, et. al. attempted to imply by questions and by objections, without producing a supporting witness, that the undisputed higher costs were offset to some degree by increased product yields. Yale, Tr. I 12. However product yields at plants are a direct function of the components of the milk received at the plant (for which plants already pay for under the Orders), the specific moisture content of the cheese, the type of cheese being produced and any inputs other than producer milk included during the

production process. In his cost survey, Ling never measured or included all of these factors in his simple mathematical calculation of the volume of cheese manufactured divided by the volume of producer milk received.

Yield factors currently in place in Federal Order provisions were determined after a lengthy hearing process and used all of those factors not considered by Ling. Those factors and other pertinent information were then inputted into an established yield formula developed by Van Slyke almost 100 years ago. In addition, all manufacturing costs considered in the hearing record were reported on a per pound of product manufactured. Any increase in yield would be reflected by an increase in total product pounds produced and therefore result in a lower manufacturing cost per pound. *See* Cryan, Tr. IV 121-22. However the bottom line of the yield issue is that it was clearly beyond the scope of the hearing notice and was merely an attempt to divert attention from higher manufacturing costs.

#### **4. The notion that notice of the hearing was not adequate.**

Some producers claimed that they were not given adequate notice of the hearing to prepare adequate opposition testimony. Tewksbury, Tr. II 23; Hall, Tr. II 37. Record evidence reveals notice beyond APA requirements (Exs. 1, 3-12, 36), and that lack of awareness of the proposal by someone with an interest in dairy regulation might be due to inaction, lack of attention or oversight on the part of the party.

The issue of inadequate make allowances and debate on the need for amendment of rules was widely reported in academic, trade and cooperative media during the period of six months prior to the hearing. Ex. 57 (U of Wisc. Briefing paper); Ooms, Tr. IV 195, Ex. 62; *See also* Oct. 05 Milkweed -[http://www.themilkweed.com/Feature\\_05\\_Oct\\_1.pdf](http://www.themilkweed.com/Feature_05_Oct_1.pdf).

More than two months prior to the hearing, USDA published on its website, and mailed to interested parties on November 11, 2005, an advance notice that the hearing was likely to take place. Poole, Tr. 411-13; Ex. 36. That mailing, as well as hearing notices, was sent by the Northeast Market Administrator to a mailing list of over 20,000 names. Producers may elect to be included on the mailing list simply by making a request to the Market Administrator. While not all producers have so requested, the Market Administrator periodically sends a notice to *all producers* reminding them of the option to be included on the agency's mailing lists. Poole, *supra*. If some persons were not aware of the hearing, it was certainly not for lack of effort by USDA.

## CONCLUSIONS

A manufacturing allowance emergency exists. The crisis is created by regulation and cannot be cured in the marketplace. The Secretary should act very quickly to amend dairy product make allowances, as proposed by proponents, with a simple and conservative increase in such allowances.

Further consideration of price formulas, including other components of the product price formula or classified pricing must not, under any circumstances, delay relief in this proceeding; nor should this hearing be reopened to consider any other pricing issue.

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Respectfully submitted,

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