

Testimony of
Michael McCully
On behalf of
Kraft Foods
At the
Federal Order Manufacturing Allowances Hearing

Alexandria, VA
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My name is Mike McCully, Associate Director of Dairy Procurement at Kraft Foods, and I am testifying on their behalf. I have worked for Kraft over 9 years and currently have responsibility for US milk procurement, US and global dairy market analysis and price forecasting, and US dairy commodity risk management. Kraft is a member of the National Cheese Institute and the International Dairy Foods Association, and this testimony supports Agri-Mark's proposal #1 and NCI's position. We also urge the Department to issue and implement a final decision and rule on an expedited basis. Kraft feels there are additional changes that need to be made to the milk price formulas, but they can be addressed in future hearings.

Kraft is both a manufacturer and purchaser of dairy products used in our retail and foodservice businesses. Kraft has manufacturing facilities and buys milk in the following states: NY (Lowville, Campbell, and Walton), PA (Lehigh Valley), WI (Beaver Dam), MO (Springfield), AR (Bentonville), ID (Rupert), and CA (Tulare and Visalia). Kraft also has other facilities that receive dairy commodities (e.g. cheese, cream, NFDM) for the production of products such as process cheese, natural cuts and shreds, frozen pizzas, and macaroni and cheese. For these facilities, we procure cheese from CA, ID, NM, CO, SD, IA,

WI, MN, IL, MI, NY, and VT, as well as import cheese from New Zealand and Australia. Kraft has closed or sold many manufacturing plants over the last 25 years and relies increasingly on dairy products we purchase from others.

For the dairy industry to be successful long-term, there needs to be a profitable dairy farm sector as well as a profitable manufacturing sector. Unfortunately, with the adoption of the current make allowances in April 2003, coupled with dramatically higher costs over the last several years, the manufacturing sector has suffered. Prior to 2000, Kraft was concerned the adoption of product formulas to price milk would lead to the very problems we've seen over the past few years. The issue we are discussing at this hearing specifically addresses the inability of manufacturers to cover increased costs through the sale of finished products. If manufacturers attempt to do this, the circularity of the formula results in the milk cost increasing by the same amount, and thus not recouping their higher costs.

The current milk price formulas use manufacturing cost data from 1997-99. Costs to dairy plants have increased, some dramatically, since that period as the following data proves. Referring to the California Department of Food and Agriculture's annual manufacturing cost studies (<http://www.cdfa.ca.gov/dairy/pdf/2005Exhibit.pdf>), the February 2000 study contained costs from 1998-99 and is therefore a comparable time period to the manufacturing allowances used in the current Federal Order formulas. From February 2000 to the November 2005 study which contained 2004 data, the manufacturing costs increased for each commodity: butter (+\$0.0411/lb or 43%),

nonfat powder (+\$0.0215/lb or 16%), and cheese (+\$0.0076/lb or 5%).

According to the Department of Energy

(<http://www.eia.doe.gov/emeu/aer/txt/stb0810.xls>), the average retail price of electricity for industrial customers has increased from 4.48 cents per kilowatthour (including taxes) in 1998 to 5.54 cents in 2005 (October YTD). This amounts to a gain of 1.06 cents or a 24% increase since 1998. Furthermore, the average price of natural gas for industrial users has increased from \$3.14 per thousand cubic feet in 1998 to \$8.00 in 2005 (October YTD)

(<http://www.eia.doe.gov/emeu/aer/txt/stb0608.xls>). This amounts to a gain of \$4.86 or an increase of 155% since 1998. Finally, looking at labor costs, the Bureau of Labor Statistics measures the cost of compensation per hour worked (<http://www.bls.gov/ncs/ect/home.htm#data>). Using the broadest measure of all compensation for all civilians, it shows the cost per hour worked has increased from \$19.76 in 1998 to \$26.05 in Q3 2005, a gain of \$6.29 per hour or 32%.

Clearly, these figures point to significant increases in the costs of energy and labor as well as the cost of manufacturing.

Moving from a macroeconomic to a microeconomic view, I'd like to provide some data specific to whey manufacturing costs. While others will give their experience with whey drying costs, Kraft does manufacture both whey powder and nonfat dry milk powder at its California plants. At the May 2000 hearing, Kraft noted consensus in testimony that it cost more to dry whey than to dry nonfat dry milk. This is due to lower solids in whey, more water to remove, and an additional manufacturing step. We also testified that, at the time, Kraft's

Tulare, CA plant had whey make costs that were 2.6 cents/lb greater than the nonfat dry milk make costs at the Visalia, CA plant. It was noted depreciation costs likely added to the whey make cost at Tulare, but the point was the cost was higher, and this difference continues to exist. Kraft also manufactures whey powder at its Campbell, NY plant. While data from 1997-99 wasn't available, the plant's cost of manufacturing whey powder has increased over 50% from 2000 to 2005.

In preparation for this hearing, we also looked at historical trends in specific costs such as electricity, energy, and labor. Again, while data from 1997-99 wasn't available, I did acquire data from one of our cream cheese plants. From 2001 to 2004, electricity costs increased 21%; natural gas costs increased 27%; and labor costs increased 10%. These cost increases clearly point to a need to update the current make allowances.

With a nationwide network of manufacturing plants and suppliers, we continually analyze costs of internal manufacturing versus purchasing from an external source. One example of this analysis is the cheese plant we used to operate in Canton, NY which made 640 lb. Cheddar blocks. On January 27, 2004, Kraft announced the closure of the Canton plant. Instead of making the cheese internally, Kraft would procure the cheese from other locations in the US, notably regions with a less onerous regulatory environment (e.g. ID) or outside the Federal Order system (e.g. CA). In the press release announcing the closure of the plant, we alluded to the unfavorable economics for continuing to operate the plant:

“As a small plant, Canton doesn’t benefit from economies of scale that could help lower overall costs and make it competitive with cheese plants elsewhere in the U.S. Plus, it lacks profitable means to process whey, a byproduct of cheese-making.”

In its last year of operation, the total cost of making cheese was \$0.23/lb which is well above the make allowance in the USDA milk formula. We use this example to point out the inherent dangers of product formulas and make allowances that do not cover smaller, less efficient plants. Our experience has shown these types of plants are not competitive in the long run, and the industry risks losing a significant number of these plants if economic conditions do not improve.

Further highlighting the financial challenges faced by cheesemakers, Dr. Ed Jesse and Dr. Brian Gould from the University of Wisconsin published a paper in October 2005 entitled “Federal Order Product Price Formulas and Cheesemaker Margins: A Closer Look”

(<http://www.aae.wisc.edu/pubs/mpbpapers/pdf/mpb90.pdf>). (presented as exhibit into evidence) In their Summary and Conclusions, they stated the following:

This analysis points out several problems with using product price formulas to establish a value for milk used to make cheese. These problems stem from the fact that product price formulas do not and cannot replicate competitive conditions except, perhaps, coincidentally. In particular, competition would dictate cheesemakers gross margins rise and fall in response to changing costs. Formulas hold margins to a fixed amount that can only be changed through a laborious hearing process.

The paper also analyzed manufacturing costs and were summarized as follows:

Using readily available cost data and numerous assumptions, we simulated the impact of higher natural gas and electricity prices on the cost of manufacturing cheddar cheese along with associated dry whey and butter. We estimate that since 2003, energy costs per cwt of milk

processed into cheese increased by more than one third, adding about 13 cents per hundredweight to manufacturing costs.

Unless offset by higher product prices, correcting the flaws in product price formulas that we have noted would result in a lower Class III price. This raises the question of whether changes would inequitably alter the sharing of revenues between dairy farmers and cheesemakers. Put more directly, farmers can argue — quite legitimately — that since they receive no assurance of profitable milk prices under federal orders, why should cheesemakers be treated any differently.

In response, we note that fixed cheesemakers margins may be fine if they assure reasonable profitability, promote efficiency and productivity growth, and encourage competition for cheese milk at prices above the federal order minimum. On the other hand, fixed margins can be a serious problem if they consistently yield sub-par returns and cause disinvestment in cheesemaking. Farmers and cheesemakers are partners — both must be profitable over the long run to sustain a healthy dairy industry.

In summary, we feel all sectors of the dairy industry need to be profitable for its long-term success. Unfortunately, the make allowances put into place in for 2003, and subsequent cost increases, have placed undue financial strains on the manufacturing sector. Therefore, we support the changes proposed by Agri-Mark and NCI's position. We feel there is a need for an expedited decision on this hearing, and request the Department issue and implement a final rule as soon as possible. I appreciate the opportunity to present Kraft's viewpoint on this issue, and welcome questions regarding my testimony. Thank you.