



International Dairy Foods Association
Milk Industry Foundation
National Cheese Institute
International Ice Cream Association

UNITED STATES DEPARTMENT OF AGRICULTURE BEFORE THE SECRETARY OF AGRICULTURE

Re: Docket No. AO-14-A74, et al; DA-06-01
Tentative Final Decision
Published November 22, 2006

COMMENTS ON THE TENTATIVE FINAL DECISION FILED BY THE INTERNATIONAL DAIRY FOODS ASSOCIATION

These comments are submitted on behalf of the International Dairy Foods Association (IDFA) and its constituent groups, and their members, with respect to the Tentative Final Decision regarding changes to the manufacturing allowances contained in the Class III and Class IV product price formulas applicable to all Federal milk marketing orders, published at 71 Fed. Reg. 67467 - 67489 (Tentative Decision). IDFA is a trade association representing processors, manufacturers, marketers, distributors and suppliers of dairy foods, including milk, cultured dairy products, cheese, ice cream and frozen desserts.

These comments demonstrate that the following three changes should be made to the provisions of the milk marketing orders contained in the Tentative Decision:

- 1. USDA should utilize the Cornell Program on Dairy Markets and Policy (CPDMP) population weighted average costs of processing for cheese in determining the make allowance for cheese.**

- 2. USDA should include the California Department of Food and Agriculture (CDFA) dry whey weighted average costs of processing in determining the make allowance for dry whey.**
- 3. USDA should update the make allowance data submitted during the hearing to reflect the increased cost of energy experienced during the period after the make allowance data was collected.**

Finally, USDA should act quickly to finalize its decision.

In addition, IDFA supports the following determinations by USDA in the Tentative Decision:

- A. USDA determined that "emergency marketing conditions exist that warrant omitting the issuance of a recommended decision. The record clearly establishes a basis as noted above for amending the orders on an interim basis." 71 Fed. Reg. Page 67487. IDFA supports this finding.
- B. USDA noted that costs of processing data from both CDFA and CPDMP were representative of actual industry costs of processing and were comparable in methodology, and therefore both should be used in determining make allowances. IDFA supports this finding.
- C. USDA noted that the cost of production survey data presented at the hearing did not include a marketing cost recovery factor, and therefore "A fixed factor of \$0.0015 will apply identically to the make allowances for cheese, dry whey, NFDM, and butter." 71 Fed. Reg. Page 67486. IDFA supports this finding.
- D. USDA noted that opponents' claim that higher yield factors would offset lower Class III and IV milk prices and producer blend prices from increased make

allowances could not be addressed at this hearing due to this proceeding being limited to make allowance factors. IDFA supports this finding.

I. USDA should utilize the Cornell Program on Dairy Markets and Policy (CPDMP) population weighted average costs of processing for cheese in determining the make allowance for cheese.

As USDA noted,

"The CPDMP study sample of cheese plants is not a random sample. It is a stratified random sample where randomness only applies to strata (size related groupings) of the surveyed plants."

And later,

"This sample design was intentionally biased to over-represent large, lower cost plants. The record shows that large plant costs otherwise would have been seriously underrepresented if the survey had relied on a truly random selection of cheese plants."
71 Fed. Reg. Page 67485.

Given these observations, which are entirely accurate, USDA in its final decision clearly should have corrected for this intentional bias in the CPDMP survey before applying the survey results to set make allowances for all Class III plants in the federal order system. By using a stratified sample, Dr. Stephenson over-sampled larger plants. Given that larger plants are, other things equal, more efficient, this meant that Dr. Stephenson was over-sampling plants with relatively low costs of processing. If one does not adjust for that fact, the survey results will significantly understate the costs of processing among cheese plants as a whole. Thus, if one does not adjust for that fact, one will set a make allowance that is too low. This is exactly when Dr. Stephenson himself advised, and he explained what needed to be done to adjust his survey results to account for his use of a stratified sample. Reconvened Hearing Exhibit 75.

The need to make this correction is particularly great given that, as Dr. Stephenson noted in his testimony, the stratified sampling technique employed was chosen for the specific purpose of providing information that could (if properly adjusted) be used to set make allowances. USDA itself sponsored and partially covered the expenses necessary to conduct the CPDMP survey of the costs of processing, and was fully aware of the sampling technique to be employed.

Q. But you understood once you were working with USDA, that it would play a role in the Federal order pricing with the make allowances?

A. Certainly did. In fact, we made a decision to select plants for this differently than we ever have in the past.

Q. Because of that?

A. Because of that.

Transcript, September 14, 2006, page 137.

Q. In providing that cost support for a portion of the project, did USDA or AMS dictate the results in any way?

A. No, not at all. They were interested in the sample or the selection of plants and how that would occur, but beyond that, it was completely hands off.

Transcript, September 14, 2006, page 114.

Therefore, USDA was not only aware of this sampling bias in advance of the CPDMP survey being conducted, but guided Dr. Stephenson to "select plants for this differently than we ever have in the past." Having used a stratified sampling technique, one obviously must adjust for that stratification when using the survey results in determining average costs of processing by all cheese plants. This is exactly what Dr. Stephenson said, and it is exactly what he did. Reconvened Hearing Exhibit 75.

USDA in its tentative decision noted that,

"Even if the methodology used to calculate the estimated make allowance of \$0.2028 per pound of cheese was statistically acceptable, the Department would not use it as the new make allowance for cheese. The use of different methodologies to establish make allowances for different products likely would result in unintended consequences that could distort the competitive situation between cheese plants and butter-NFDM plants."

71 Fed. Reg. Page 67486

The comment misperceives the situation. The "use of different methodologies" did not relate to CPDMP's calculation of a population weighted average for cheese but not for the other products, but rather referred to the use of a sampling technique for cheese that was different than the sampling methodology employed for the other products. The cheese costs of processing survey was developed using a **stratified** random sample, while the surveys for the other products used a **non-stratified** random sample. There was thus an inherent need to correct for stratification with respect to the cheese survey, and inherently no need to do so for the other surveys.

Having adopted a stratified sample technique for cheese (a methodology different than that employed for the other three products), one cannot fail to take the necessary next step and correct for the stratification when applying the results to cheese plants as a whole as a necessary result of having decided to use a different sampling methodology in the first place. There was no *a priori* statistical reason to make such a correction to the sample results for dry whey, butter and nonfat dry milk because a stratified sample had not been used.

The fact that, as USDA notes, "*CPDMP did not have similar population data available to do comparable regression analyses for butter, NFDM and dry whey,*" **thus becomes irrelevant.**

USDA observes that:

"It is possible that if the regression methodology could be used for butter, NFDM and dry whey that estimated average make allowances for those products also would be higher than the weighted average costs from the plant samples."

71 Fed. Reg. Page 67486-7.

This might be true, but we do not know whether this is true, and do not need to know because a stratified sample was not used for these other products. The reasons why such

a stratified sample was used for cheese, and properly so, were recognized by USDA and are discussed above. Cheese plants cannot be saddled with a make allowance that is too low merely due to speculation as to what the make allowance might be for other products had alternative survey methodologies been utilized for them.

Therefore, USDA must correct for the intentional sample bias in the CPDMP cheese costs of processing survey and use the corrected population weighed average estimate for this product's cost. It is, therefore, Dr. Stephenson's final calculation, as he himself labels it, the "Weighted Average Processing Costs for Cheddar Cheese" plants outside of California that must be used. Indeed, Dr Stephenson explicitly testified at the hearing that, if he had to pick one value to represent the cost of processing cheese which USDA should use as the CPDMP cheese costs of processing value to use in determining the make allowance for cheese, that was it.

Table 1 shows the method used by USDA in the Tentative Decision to determine the make allowances to be used from combining the CPDMP and CDFA data. That table also shows how the use of the population weighted average processing costs for cheddar cheese as testified to by Dr. Stephenson should replace the sample weighted average cost used by USDA in the Tentative Decision, by replacing the \$0.1638 sample average with the \$0.2028 population average. When combined with the CDFA data using the NASS 2005 Dairy Production American cheese volumes for the two areas, the result of this change alone is a make allowance for cheese of \$0.1986.

II. USDA should include the California Department of Food and Agriculture (CDFA) dry whey weighted average costs of processing in determining the make allowance for dry whey. As USDA repeatedly noted in the Tentative Decision, the CDFA data on the costs of processing represents an audited survey of manufacturing plants in that state. The CDFA survey data results have been endorsed and utilized by USDA since 2001 to set make allowances. USDA nonetheless only used the CPDMP data in setting the whey make allowance. IDFA submits that this was in error.

USDA stated that:

"In the CDFA survey, dry whey drying costs may be unreasonably high because California has only three dry whey processing plants where high cost plants appear to skew the costs dramatically."
71 Fed. Reg. Page 67485.

No data was presented at the hearing which could allow USDA to reach such a conclusion, given that individual plant data was not revealed and therefore no determination can be made about the distribution of costs of processing among the three plants in the CDFA survey.

In fact, the data that is available points to the opposite conclusion than that reached by USDA. USDA NASS reported that there were only 5 plants in California producing dry whey in 2004, and the three plants (60% of all the dry whey plants in California) in the CDFA cost survey represented nearly 79% of the USDA NASS reported dry whey production in that state that year. The two plants not in the survey have far less volume processed, on average, than the three plants which were included in the CDFA survey. Give the record evidence as to the positive effect of economies of scale on processing costs per hundredweight with respect to all dairy products, these two excluded plants in all likelihood had materially higher costs per hundredweight than the

three surveyed plants. The CDFA data, if anything, under-reports the average costs of processing dry whey for all five plants in that state.

In addition, a comparison of the average volume processed per dry whey plant among NASS, CPDMP, and CDFA reveals that it is the CPDMP data that is less comparable to the national average plant size than the CDFA data, not the other way around. Data from CDFA (Hearing Exhibit 23), CPDMP (Reconvened Hearing Exhibit 76) and USDA NASS (Official Notice taken, September 14, 2006 Transcript page 236) appear in the IDFA post hearing brief attachment submitted October 2, 2006. The average dry whey plant in the CPDMP survey processed over 77% more volume than the NASS national average, while the average dry whey plant in the CDFA survey only processed 16% more. Therefore, the CDFA survey is more representative of the U.S. average than the CPDMP survey with respect to the costs of processing dry whey.

USDA should therefore include both the CDFA and CPDMP survey weighted average data in determining the dry whey make allowance. Table 1 shows how USDA only used the CPDMP data to determine the dry whey make allowance in the Tentative Decision, and also shows how the CDFA data should be incorporated in determining the dry whey make allowance using the same methodology as that used by USDA to combine the CDFA and CPDMP data for the other three products. Incorporating this change alone, USDA should adopt a dry whey make allowance of \$0.2043.

III. USDA should update the make allowance data submitted during the hearing to reflect the higher cost of energy in the period after the submitted make allowance data was collected. USDA must account for the very real fact that costs of manufacturing have escalated since the period the CDFA and CPDMP data was collected. As Dr. Stephenson testified, at least 84% of the monthly data submitted for the CPDMP survey were for months prior to July 2005, more than 18 months ago. The increased energy costs experienced by dairy manufacturing plants, both cooperative-owned and proprietary, prior to the January 2006 hearing were testified to by numerous representatives of dairy manufacturing plants.

Dr. Stephenson in his testimony addressed the impact of energy costs on the costs of processing. Dr. Stephenson combined data from the Bureau of Labor Statistics' published producer price indexes (PPI) for industrial electric power and natural gas with data from the energy cost estimates from the CPDMP survey to estimate the impact of higher energy costs in 2005 on the costs of processing. USDA should add Dr. Stephenson's energy cost updates to the CDFA and CPDMP costs of processing to insure that the make allowances adopted by USDA reflect the most current data available on the costs of processing.

Table 1 shows how the data presented by Dr. Stephenson should be incorporated into the make allowances by USDA, by adding the final energy cost factors from Dr. Stephenson's testimony directly to the average costs of processing from both the CDFA and CPDMP surveys weighted by the USDA NASS data on dairy product production in California and the rest of the U.S. USDA should adopt a cheese make allowance of

\$0.2020, a dry whey make allowance of \$0.2119, a butter make allowance of \$0.1231, and a nonfat dry milk make allowance of \$0.1640.

IV. USDA Must Take Care Not To Set Make Allowances Too Low. In setting make allowances, USDA must bear in mind the tremendous problems it creates when it sets make allowances that are too low as compared to actual costs of manufacturing. At the hearing held January 24-27, 2006, numerous witnesses testified to the nature and impact of the price formulas used in FMMO's since January 1, 2000 (Yonkers, Wellington, Schad, McBride, Cryan, and McCully). Oversimplifying slightly, the current product price formulas set the minimum prices that farmers must be paid for their milk as the price handlers receive for their finished products (such as cheese or butter) minus the costs the handlers incur in turning farm milk into those finished products (commonly referred to as the "make allowance").

Therefore, the make allowance becomes the fixed difference between the wholesale sales value of a manufactured dairy product and the minimum regulated cost to purchase the raw milk necessary for that product's production. This make allowance must be high enough to perform numerous functions, e.g., to pay for the use of the capital necessary to build and maintain the plant, to cover the non-milk costs relating to obtaining raw milk, to pay for marketing the processed dairy product, to pay wages to employees of the manufacturing plant, to pay utility companies for the water, electricity and natural gas used to manufacture the dairy product, to buy ingredients other than raw milk, and to cover a wide variety of other expenses such as plant maintenance, equipment, and insurance.

As Wellington noted, "Manufacturing allowances that are fixed in the class pricing formulas bear no relationship with the selling prices of any of the dairy products mentioned or the prices received by farmers for their milk. If cheese, butter, nonfat dry milk (NFDm) and whey powder prices were to double tomorrow, Class II and IV prices and farm prices would more than double, but manufacturing plants would receive the exact same allowance. In fact, manufacturing costs for energy, insurance, labor, capital and/or any other input could double yet the manufacturer would not get one penny more to cover those costs under the existing order provisions."

Schad noted that "The manufacturing allowance is fixed; any increases to the selling price to capture increased costs are reported to NASS and all dairy farmers, regardless of whether their marketing organization incurred the costs, benefit from the higher class prices."

McCully noted that "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."

Cryan noted that "Federal order milk prices are minimums, so that if the demand for milk is strong enough, the market will produce price premiums above the USDA-set minimum. By contrast, make allowances define a maximum milk-to-cheese margin that

the average cheddar cheese maker, for example, can get for his trouble. Since the current formulas define milk prices as a fixed function of the product prices, the milk price rises when the average product price rises. If the fixed margin becomes inadequate to cover costs for the average plant, there is no room for processing premiums. That is, while market forces can correct regulated milk prices that are too low, the make allowance can only be adjusted by USDA. Under current conditions, these make allowances are too low. This undermines the ability of Federal order-regulated plants to operate. This, in turn, undermines Federal orders, which rely on manufacturing plants, including especially cooperative plants and cooperative-supplied plants, to balance overall milk supplies. If those outlets are pushed into state-regulated and unregulated markets, they cannot effectively provide those services, putting all participants in Federally-regulated markets at a disadvantage."

Every witness for companies that manufacture Class III and IV products noted the problems created when manufacturing margins are fixed and manufacturing costs beyond their control increase. Wellington, representing a cooperative, in particular noted that the losses created from this problem are borne unequally by producers when those producers are members of a cooperative that owns and operates plants which process Class III and IV products.

Given the tremendous problems created when make allowances are set too low, it is instructive to note that since April 2003, the make allowances have been based on industry cost data from 1997-1999 presented at a May 2000 hearing. The tremendous time lag in adjusting make allowances to reflect increased costs counsels strongly against undue conservatism when setting make allowances.

At the reconvened hearing, Dr. Stephenson noted that for cheese, his estimate of the weighted average cost of processing for the population of cheese plants located outside of California would fail to cover the cost of processing for about 67 percent of such plants. Thus, there can be no basis to argue that the make allowances being urged by IDFA, based on the weighted average CDFA and CPDMP data, are too high.

For all these reasons, it is imperative that USDA act promptly to adopt the three changes urged by IDFA.

Respectively Submitted

A handwritten signature in black ink, appearing to read "Robert D. Yonkers", written in a cursive style.

Robert D. Yonkers, PhD.
IDFA Chief Economist

Table 1

Tentative Decision	Butter	Nonfat Powder	Cheese	Dry Whey
Total 2005 US NASS Volumes	1,347,227	1,186,104	3,812,950	963,716
CDFA weighted average costs	0.1370	0.1730	0.1770	NA
CA NASS volumes	407,872	506,452	854,704	119,215
CA share of NASS	0.30	0.43	0.22	0.12
CPDMP sample weighted average costs	0.1108	0.1423	0.1638	0.1941
Non-CA NASS volumes	939,355	679,652	2,958,246	844,501
Non-CA share of NASS	0.70	0.57	0.78	0.88
CDFA and CPDMP weighted by NASS	0.1187	0.1555	0.1667	0.1941
Add marketing costs	0.0015	0.0015	0.0015	0.0015
Tentative decision make allowances	0.1202	0.1570	0.1682	0.1956

Analysis of IDFA Comments	Butter	Nonfat Powder	Cheese	Dry Whey
Total 2005 US NASS Volumes	1,347,227	1,186,104	3,812,950	963,716
CDFA weighted average costs	0.1370	0.1730	0.1770	0.2670
CA NASS volumes	407,872	506,452	854,704	119,215
CA share of NASS	0.30	0.43	0.22	0.12
CPDMP population weighted average costs	0.1108	0.1423	0.2028	0.1941
Non-CA NASS volumes	939,355	679,652	2,958,246	844,501
Non-CA share of NASS	0.70	0.57	0.78	0.88
CDFA and CPDMP weighted by NASS	0.1187	0.1555	0.1971	0.2028
Add marketing costs	0.0015	0.0015	0.0015	0.0015
IDFA comment make allowances	0.1202	0.1570	0.1986	0.2043
Add Cornell Energy Cost Update	0.0029	0.0070	0.0034	0.0076
IDFA comment with energy adjusters	0.1231	0.1640	0.2020	0.2119