

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

IN RE:		
MILK IN THE NORTHEAST AND		
OTHER MARKETING AREAS;		Dockets: AO-14-A77
Class III/IV PRICING FORMULAS		DA-07-02
72 Fed. Reg. 6179 (Feb. 7, 2007), and		
72 Fed. Reg. 7753 (Feb. 20, 2007		

POST-HEARING BRIEF OF AGRI-MARK, ET AL.

This post-hearing brief is submitted on behalf of Agri-Mark, Inc., Associated Milk Producers, Inc., Foremost Farms USA Cooperative, Land O’Lakes, Inc., Michigan Milk Producers Association, and Northwest Dairy Association -- all producer-owned dairy cooperative associations, collectively referred to as “Agri-Mark, et al.” or “Operating Cooperatives”. The cooperative associations market milk produced by member dairy farmers to handlers in federal milk marketing orders (“FMMOs”) and operate manufacturing plants in which FMMO-pooled producer milk is converted to cheese, dry whey, butter, nonfat dry milk, and other dairy products.

INTRODUCTION AND BRIEFING SUMMARY

Over the past 10 years, USDA and the dairy industry developed end product pricing formulas for Class III and IV uses of producer milk in Federal Milk Marketing Order (“FMMO”) after reluctant acceptance of the reality that truly competitive prices to measure the value of farm milk, such as employed in the former M-W price series, could not longer be reliably ascertained. Finished dairy product commodity prices are, however, still determined by a competitive market. Product price formulas seek to estimate, by economic theory and regulatory reconstruction, a margin between product prices and producer milk value that was previously measured by competition.

Because product price formulas are embedded by regulation for years, while unfettered competition responds daily to manufacturing cost changes and other margin factors, product price formulas will inevitably become outdated and require periodic revision. The USDA make allowance hearing of 2006 sought to update, on an emergency basis, the most significant component in the constructed margin. As described below, the 2006 hearing produced interim make allowances that, while mitigating a crisis, fell far short of correcting the problem.

In this proceeding, every element of and issue relating to the product price formulas is on the table. The dairy industry took the opportunity to test administrative assumptions, challenge opponent assumptions, identify mistakes, learn from past oversight, and develop a new record of best available evidence on the issues.

Agri-Mark, et al., believe that regulatory policies and underlying economic theory that have guided product price formula decision-making in prior hearings are generally sound, and should continue to guide the future. It has been in applying policy and theory to specific circumstances, and in the mere passage of time, that there have evolved some serious gaps between policy and pricing result. Agri-Mark, et al., by proposals, hearing testimony, hearing advocacy, and by this brief, hope to bridge these gaps by: (1) USDA's adoption of make allowances that are more representative of FMMO plant costs; (2) provisions to more reliably measure and respond to changes in manufacturing costs for representative plants; and (3) corrections or improvements in the assessment of market-driven product values, and in the translation of product prices to imputed values of raw farm milk components.

OVERVIEW OF DECISION-MAKING STANDARDS

Section 556 (d) of the Administrative Procedure Act ('APA') places the "burden of proof" on a proponent of a rule to come forward with facts and arguments in support

of a proposal. It is now understood that the “burden of proof” as to proponents in formal “on the record” hearings under the APA – as is the case for this hearing -- imposes a traditional “preponderance of evidence” burden on the party or agency proposing a rule or order. *Director, Office of Workers' Comp. Programs v. Greenwich Collieries*, 512 U.S. 267, 276 (1994). In the discussion that follows in this brief, it will be seen that some proponents have not even met the less demanding pre-existing standard of “going forward” with credible evidence. *See NLRB v. Transportation Mgmt. Corp.*, 462 U.S. 393, 404 n.7 (1983). Such unsupported proposals should be summarily rejected by the agency, allowing precious decision-making resources to be devoted to proposals supported by substantial record evidence and by reasonable inferences based on such evidence.

The APA, the AMAA of 1937, and court decisions applying these statutes also provide general standards for USDA’s decision-making. In general, a rule will be upheld if it is authorized by statute and if the agency decision supporting the rule (1) addresses all relevant factors, (2) examines all relevant data, (3) makes findings supported by substantial record evidence, and (4) provides a “rationale connection between the facts found and the choice made.” *Motor Vehicle Manufacturers Association v. State Farm Mutual*, 463 U.S. 28, 43-48 (1983).; *Rhode Island Higher Educ. Assistance Auth. v. Secretary of Educ.*, 929 F.2d 844, 855 (1st Cir. 1991); *Indiana Forest Alliance, Inc. v. United States Forest Service*, 325 F.3d 851 (7th Cir. 2003); *Bagdonas v. Department Of Treasury*, 93 F.3d 422 (7th Cir. 1996).

One of the practical functions of 5 U.S.C. §557’s requirement of findings and reasoning “on all material issues” in formal rulemaking hearings is “to preclude later controversy as to what the agency had done” and “to advise the parties and any reviewing court of their record and legal basis.” *The Attorney General’s Manual on the*

APA (1947) at 85-86. This function is particularly important where an agency desires to depart from or alter its own established precedent and policy. Agencies may not treat similar circumstances differently or reverse established policies without clear explanation. *Yetman v. Garvey*, 261 F.3d 664 (7th Cir. 2001).

The standards, procedure, relevant factors, and other components of current USDA make allowance policy have evolved and been refined since the 1999 Federal Milk Order Final Decision, 64 Fed Reg. 16026 (Apr 2, 1999) (“Reform Decision”). Some of the proposals in the current hearing would, if adopted, require significant alteration or reversal of established policy.

In some cases, the result or application of a past decision to market participants has contradicted express policy without any agency acknowledgement of or explanation for the implicit policy change. For example, in the Tentative Final Decision (“TFD”) on make allowances in the emergency hearing that concluded last fall, 71 Fed. Reg. 67467 (Nov. 22, 2006), the AMS Administrator adopted interim make allowance amendments reflecting actual weighted average manufacturing costs for surveyed plants. The average size of surveyed plants, however, was much larger than typical or representative plants in federal milk markets, and very much larger for some products such as cheddar cheese. In some milk manufacturing regions there are very few plants, and in other manufacturing markets no plants, as large as the plant size for which there is an implied make allowance “fit” under the interim decision. Since manufacturing cost differences between plants are highly correlated to size differences, as the Administrator acknowledged, the TFD make allowances will not cover the cost of most milk commodity manufacturing plants, nor even cover the costs of a substantial minority of plants.

The result of TFD make allowances may illustrate an unexplained departure from established agency policy that make allowances should “cover the costs of *most* of the

processing plants that receive milk under the [federal milk] orders,” as discussed below. It may, admittedly, instead represent a very conservative response to proposed interim make allowance amendments, limited to the emergency procedure setting of the 2006 hearing, without intending to repudiate past policy for application to the future in full-procedure hearings.¹ In either event, the apparent inconsistency should have been more clearly explained.

Conforming to standards in the APA and in USDA’s Rules of Practice, the Secretary’s delegated decision-makers are urged in this proceeding to boldly confront and clearly explain all policies and reasons underlying their decisions in order to provide the requisite rational connection between the facts found and the choices made.

PROPOSED FINDINGS OF FACT AND ARGUMENT ON THE ISSUES

I. UPDATE AND REVISION OF CURRENT MANUFACTURED PRODUCT MAKE ALLOWANCES (Proposals 1, 3, 17).

The Operating Cooperatives all support Proposal # 1, submitted by Agri-Mark, to update make allowances in the Class III and IV product price formulas based on the best available and most current evidence of representative plant manufacturing costs.

USDA again has a duty to examine, test, and resolve issues of fact, law, and policy that apply to the ultimate question: “what are reasonable rates to cover representative plant costs for converting producer milk to marketable dairy commodity

¹ Use of “interim rates” with adjustments after full record development is not uncommon in other regulatory agencies. *Qwest Corp. v. Koppendrayner*, 436 F.3d 859 (8th Cir. 2006); *BP West Coast Products, LLC v. FERC*, 374 F.3d 1263 (D.C. Cir. 2004); *Worldcom, Inc. v. Connecticut Department of Pub. Util.*, 375 F.Supp.2d 86 (D. Conn. 2005); *National Air Carrier Association v. CAB*, 436 F.2d 185, 194-95 (D.C. Cir. 1970) (judicial review of interim rates is more deferential than review after development of a full record).

products.” Subsidiary questions include: (1) what are the characteristics of typical plants or “representative” plants whose costs should be included or covered? (2) can at least some plants, or even one plant, in each manufacturing market recover costs from the adopted make allowance for each product,² (3) have all costs been identified ? (4) how may ascertained costs for atypical plants, unique production regions, or older cost data, be extrapolated to reflect or to estimate reasonable current costs for representative plants? and (5) what are the regulatory policy objectives that should guide the inquiry? We address these questions first by examining the foundation laid in seven decades of USDA decisions and publications on make allowance issues, including the most Tentative Final Decision of November 2006.

A. Make Allowances, Objectives, and Stated USDA Policies.

(i) History of and Policy for Make Allowances 1937 – 2000.

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.”

² As a corollary to inquiry # 2, if it is unnecessary or unreasonable as a matter of policy for at least one plant in each product category to be assured cost recovery from make allowances in each manufacturing market, how can this be reconciled with policies expressed in prior decisions and legal standards of *Federal Power Commission v. Hope Natural Gas Co.*, 320 U.S. 591(1944), that regulated rates should allow for recovery of costs *plus* a reasonable return on investment. See discussion at p. 16 of Post-Hearing Brief of Proponents in Dkt. AO-14-A74, reproduced at http://www.ams.usda.gov/dairy/proposals/Post_hearing_Briefs/Agri-Mark,%20et%20al..pdf .

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 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).³

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:

³ 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.

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. Diminished production and fewer buyers of unregulated Grade B milk necessitated this change. 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), 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; and the TFD issued in November 2006, 71 Fed. Reg. 67467.

(ii) Federal Order Reform and Post-Reform Make Allowance Policy.

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 current milk product price formulas.

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 producer 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).⁴
- (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 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 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. *Federal Power Commission v. Hope Natural Gas*, *supra.*, note 2.

- (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.”).⁵
- (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, 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 67915.⁶

⁵ FMMO manufacturing plants typically serve to help balance milk supply and demand, which may add to per unit make costs for representative FMMO plants. If the Secretary decides to reverse policy, that reversal should be unequivocally stated so as to re-open the door for such additional costs to be recovered in the form of market-wide service payments.

⁶ California’s milk pricing authorities have set the gold standard for manufacturing cost survey methodology, as well as for regulatory responsiveness to changing circumstances by product price formula amendments. CDFA has conducted several make allowance hearings since 2000, and will hold a hearing this fall to consider elimination of whey pricing from the California cheese (Class 4-b) formula. http://www.cdfa.ca.gov/dairy/dairy_hearings_matrix.html.

(iii) The November 2006 Tentative Final Decision on Make Allowances.

As previously observed in the introduction, the make allowances adopted by last November's TFD appear to depart *in result* from policies and objectives expressed in prior agency decisions, but that may be due to the "emergency" nature of that proceeding and the "interim" application of its results. TFD, 71 Fed. Reg. at 67467. The policies and principles expressed in the TFD, however, are largely consistent with and reinforce prior make allowance decisions.

Make allowances should be representative of plants and plant costs. The Administrator explained in the TFD that: "The make allowance factor represents the cost manufacturers incur in making raw milk into one pound of product" (id. at 67469). In his "Discussion and Findings," the Administrator lauded CDFA's manufacturing cost surveys because they "represent[] manufacturing cost data for almost all plants located in California" (id. at 67484). He questioned the usefulness of cost surveys by USDA's RBCS because (in his opinion) it did "not provide a comprehensive view of manufacturing costs across plants in the Federal order system" (id.), and concluded in particular that fuel costs reported in the RBCS survey does not "reasonably represent[] the costs of fuels experienced by manufacturing plants." Throughout his discussion and findings on plant costs evidence and cost surveys, the Administrator consistently analyzed the how he believed the surveyed cost data should be applied to "best represent" the "cost of processing by manufacturing plants in the Federal milk order program" for cheddar cheese, dry whey, butter and NFDM (id. at 67486 - 87). These principles are consistent with make allowance decisions from 1999 through 2005.

Manufacturing cost surveys should reflect the fact of economies of scale, but applied to avoid undue size-bias in make allowance result. In the TFD, the Administrator gave special attention to the undisputed fact that, for all dairy products,

“larger plants hav[e] significantly lower per unit costs of processing than smaller plants,” which is consistent with “expectations of economic theory.” *Id.* at 67484. The Administrator insisted, quite reasonably, that one test of cost survey credibility was whether the survey reflected this economic fact; and he rejected use of the RBCS survey on the belief (albeit an erroneous belief) that the RBCS survey results did not conform to the expectations of economic theory for economies of scale. *Id.*⁷ Finally, the Administrator cautioned that, in the face of known economies of scale for larger plants, cost surveys should be designed and used so as to avoid “size bias” in the regulated result.⁸ *Id.* This implies that the size and other characteristics of a “representative” plant or grouping of plants should first be determined, so that the decision-maker may assess, and affected parties may knowingly question, whether a particular survey result meets the standard or is size-biased by over-representation by large or small plants.

⁷ The RBCS survey of 2004 plant costs presented on the 2006 hearing record revealed, consistently, that simple average costs for surveyed plants were *higher* than weighted average costs. Ex. 33-000. This could not have occurred unless the surveyed plant costs, consistent with economic theory, were lower for large volume plants than for lower volume plants.

⁸ For example, the 2006 CPDMP survey was intentionally designed to capture large plants by a separate “stratified” sample. As explained by Dr. Stephenson and endorsed by the Administrator, this was necessary because, in the relatively large population of 113 “C3” cheddar cheese plants, there are few large plants (Ex. 36, pp 4, 7; Ex. 37). A random draw of 20 plants for survey purposes would therefore over-represent small plants, over-represent Midwest plants, and reveal little about large western plants. Such large plants, though few in number, produce a large portion of commodity cheddar cheese. Ex. 36, p. 4; 71 Fed. Reg. at 67485. The CPDMP survey was designed to draw 5 plants from the largest 10% (11 plants) of 113 plants in the population. Almost 50 % of the large plants, therefore, were solicited for the survey, of which 3 participated in the 2006 CPDMP results. Of the remaining 90% of the plant population (102 plants), 15 were drawn and solicited for the 2006 survey (i.e., 15% of plants), of which 13 responded and were included in results. Exs. 36-37; Ex. 72; Tr. 2542-3, 2769-75. This sampling process produced an admitted size bias in the weighted average costs for the 16 surveyed plants, and the size bias was later aggravated in the 2007 CPDMP survey by fewer small plants, and more large plants, represented in the results.

Where survey evidence does not allow for direct conclusions about representative plant costs, best available evidence should be used to extrapolate costs for representative plants. As Dr. Stephenson explained, the ultimate statistical objective of a survey is “to extrapolate from the data you have collected to make general conclusions about the larger population from which the data sample was derived.” Ex. 36, p. 4. The Administrator’s TFD likewise reaffirmed that is useful in decision-making to extrapolate cost estimates for representative plants where the structure, design, or content of proxy data in a survey may fall short of the precise regulatory objective.⁹

In the TFD, butter plant costs illustrate this principle. Dr. Stephenson reported that he did not have confidence in the results of the 2006 CPDMP butter plant survey as representative of the plant population for several reasons. Ex. 36 p. 5. The Administrator agreed, concluding that the CPDMP survey was not one upon which federal order butter plant “costs can be reasonably based.” 71 Fed. Reg. at 67487. The TFD, therefore, relied more heavily upon CDFA surveyed costs because there “was no other better source of cost data” to estimate manufacturing costs for butter plants in the federal marketing orders. *Id.* This approach was consistent with USDA’s prior heavy reliance upon RBCS cost survey results from 1999 through 2005 “because at the time, no other cost information was available from which to assess manufacturing costs for FMMO plants.” *Id.* at 67484. As described below, use of extrapolation and proxy group evidence continues to be necessary in this proceeding to draw conclusions about costs of representative plants – particularly for cheese plants, due to the significant large plant size bias of the 2007 CPDMP survey results.

⁹ Use of data from proxy groups to fix rates for a regulated business or target population is a long-established and accepted regulatory practice where the proxy group and regulated entities share sufficient characteristics in common. *See* discussion in *Petal Gas Storage, L.L.C. v. Federal Energy Regulatory Commission*, No. 04-1166 (D.C.Cir. 08/07/2007), and *Permian Basin Area Rate Cases*, 390 U.S. 747 (1968);

B. Best Record Evidence of Current “Representative” Plant Make Costs.

The goal of Proposal 1 is to revise the product make allowances in §1000.50 based upon facts reported in, and reasonable extrapolations from, all available manufacturing cost surveys, so that final make allowances reflect current costs of representative plants and may reasonably be applied to future milk price regulation. The current manufacturing cost allowances are a result of the Tentative Final Decision (TFD) from the 2006 Hearing (71 Fed. Reg. 67467), which combined the manufacturing cost surveys compiled by The California Department of Food and Agriculture (CDFA) for 2004 and the Cornell Program on Dairy Markets and Policy (“CPDMP” or “Cornell”) presented at the 2006 Hearing. For the TFD, the Administrator weighted the cost averages of the CDFA survey by the total commodity volume produced in California with the Cornell average cost weighted by the total product volume, produced outside of California, as reported by the National Agriculture Statistics Service (NASS).

The Operating Cooperatives recommend that USDA adopt Proposal 1 by:

1. Updating the manufacturing cost allowances based on the reported costs found in the CDFA Summary of Weighted Average Manufacturing Costs (Exhibit 10) and the Cornell Manufacturing Cost Survey (Exhibits 72 and 76):
2. Weighting the CDFA and Cornell Surveys by NASS commodity volumes, consistent with the methodology of the TFD;
3. Substituting the Cornell sample weighted average cheese plant costs with an estimated population weighted average, or by comparable extrapolation, to provide reasonable and current estimated costs of representative plants; and by
4. Including the CDFA manufacturing cost of whey production in the whey manufacturing cost allowance.

Both the most recent CDFA and the Cornell manufacturing cost surveys point to increased manufacturing costs incurred by processors during the most recent survey periods. CDFA surveys of manufacturing plants for 2005 and 2005 revealed a year to year increase in the weighted average cost of butter production by \$0.0040 (3%); cheddar cheese by \$0.0145 (8%); whey by \$0.0178 (7%) and NFDM by \$0.0139 (8%) per pound. The manufacturing costs at plants in the federally regulated areas have increased even more dramatically between 2006 and 2007 surveys. The weighted average cost of butter manufacturing, as reported by Cornell, increased by \$0.0738 (67%); whey by \$0.0035 (2%) and NFDM by \$0.0239 (17%) per pound. In summing up his more recent survey, Dr. Stephenson wrote, “Over that year-and-a-half, plants have continued to observe increased costs of processing.” (Exhibit 72, pg. 10) The following comparison illustrates that the current make allowances are inadequate to cover current manufacturing costs:

Comparison of Current Weighted Average Manufacturing
Costs and FMMO Make Allowances

	FMMO Make Allowance	CDFA Population* Wtd	Cornell Sample Wtd
Cheese	\$0.1682	\$0.1914	\$0.1584
Whey	\$0.1956	\$0.2851	\$0.1976
Butter	\$0.1202	\$0.1408	\$0.1846
NFDM	\$0.1570	\$0.1872	\$0.1662

While Cornell’s 2007 survey reported that weighted average cost of *sampled* cheddar plants was \$0.0054 per pound less than for 2006 sampled plants, Dr. Stephenson also reported that the average sample plant volume doubled between the periods by addition of volume from new large plant survey participants, and fewer small plant participants. Tr. 2542-3; 2769-75. Such an increase of volume would result in additional

* Since CDFA surveys costs for almost all plants, its calculated weighted average costs are fairly described as “population weighted.” Cornell’s survey, in contrast, was deliberately designed to produce size-bias in its cheese results. For all products, the Cornell weighted average results apply only to the survey sample, not necessarily to the FMMO plant population.

size-bias for the 2007 sample weighted average costs.¹⁰ However, in a comparable plant-to-plant comparison of the eight plants included in both surveys, Dr. Stephenson reported that processing costs increased by \$0.017 per pound; Ex. 72, p. 6; Tr. 2781. Plainly, the current make allowances are inadequate to cover the costs of processing.

The Operating Cooperatives argued in their Comments on the TFD, and reaffirm on the basis of this record, that USDA should include the CDFA cost of whey processing in the make allowance calculation for whey. The CDFA whey cost survey represents 82-percent of the whey processed in that state. CDFA is the “gold standard” for manufacturing cost surveys. CDFA has surveyed whey plants and observed the costs of whey manufacture at consistent levels for three years and have used the results in setting the California make allowances.

The California Department of Food and Agriculture (CDFA) conducts an annual survey of dairy plant manufacturing costs within its state. The costs reported use a procedure that has been in place for many years and are audited. CDFA data are representative of the costs of plants throughout the state because the survey included most of the appropriate plants that produce most of the volume of products under consideration. The only criticisms expressed for some of the CDFA survey data, for extrapolating and estimating FMMO plant costs to be included in make allowance changes, are: (1) that the plants involved do not use Federal Order pool milk and (2) they may not provide a representative sample of plants in other areas of the country. The criticisms, illogically, would not allow for any extrapolation of make costs from the very best evidence of record.

¹⁰ Because of their inherent and deliberate size bias, the Cornell cheese plant surveys must only be used as one of several sources to extrapolate costs for representative FMMO cheese plants, as discussed in following arguments, rather than adopted as revealing the costs of representative plants.

The intent of the Cornell survey is to determine manufacturing costs at a sample of plants located outside of California. The methodology used by Cornell was based upon the CDFA survey. Ex. 72. It would therefore be consistent to combine the two data surveys to draw cost conclusions for the surveyed plants, and cost inferences for representative plants. However the Cornell survey is not audited. The original intent of the Cornell survey was also to use a representative sampling of manufacturing plants so the costs determined would adequately represent the costs of all plants in the U.S. outside of California. The hearing record shows that such a representative sample was not available for cheese as it was also not available for butter in Cornell's first survey. Ex. 72; Tr. 2542-3, 2767-75. Even greater concerns are identified, but not resolved in the record, with respect to the manufacturing costs for whey powder by representative cheese plants, to provide a Class III price that fairly captures both cheese and by-product revenue less reasonable plant costs for the product combination.¹¹

¹¹ Whey cost and revenue issues are undoubtedly the most difficult for USDA to apply in reasonable Class III product price formula decision-making.

As to manufacturing costs, the whey make allowance must account for reasonable costs incurred between the manufacturing stages of whey steam production in cheese making through packaging of finished whey powder. However, most cheese plants do not make whey powder or any other whey product (see: Dairy Programs, AMS, USDA *Dairy plants Surveyed and Approved for USDA Grading Service*), but rather condense whey and ship it to other plants for manufacturing. Thus, representative costs of condensing, handling and transportation of whey from the cheese whey stream to whey plants must be included somewhere in the product price formula (cheese or whey costs), or the resulting imputed value in the Class III price will surely be overstated because an important component of cheese and byproduct costs would be missing. Likewise, reliance on whey processing costs at large plants that receive whey from many plants as "the" whey make cost will size-bias the result and understate costs for a representative plant the makes cheese and manufactures whey by-products from its cheese production.

As to imputed gross by-product revenue to cheese makers, there are many products manufactured from whey. Whey powder is not the majority of such product production, but whey powder prices are nevertheless used as the only product revenue proxy in the Class III formula for skim whey resulting from cheese production. Because market prices for whey powder and other whey products respond to discrete and individual supply and demand

Without representative surveys of dairy product manufacturing costs in plants using Federal order pool milk, at the very least, USDA should not use the limited cost data available to the record and apply it across all non-California dairy product volumes as if it represented the average costs of producing those products in FMMO plants. Instead USDA should accept that it does have plant cost data for a large number of plants (combining CDFFA and Cornell data) and the data was reported using a consistent methodology. If USDA is to use the Cornell data, it should not use those costs and apply them across plant volumes for which they are not representative as the agency did in the TFD. USDA could consider all the plant costs and volumes reported through the CDFFA and Cornell surveys as highly credible cost observations for plants sampled, and the best information available of record which can be used to determine the appropriate manufacturing allowance as sought in proposal #1. Under this method, costs should be weighted using the plant volumes to which they apply, but not used to imply costs for plant populations that they do not represent.

The following table shows the make allowances prior to the December 29, 2006 interim rule (original), the allowances proposed by Operating Cooperatives in the 2006 proceeding ('06 proposed),¹² the allowances implemented by USDA under that rule

characteristics, these whey market prices do not move up and down in sync with each other, and may in fact move in opposite directions. This has the potential to produce, and has in fact produced, Class III prices that imply severely distorted (and over-stated) whey revenue to cheese makers.

¹² http://www.ams.usda.gov/dairy/proposals/Reconvened_Post_hearing_Briefs.htm , post-hearing brief of Agri-Mark, et al. The 2006 briefs of the Operating Cooperatives identify additional factors significant to make allowances, and record evidence in support. Exception is hereby taken to the rulings of the presiding ALJ, for reasons briefed during the hearing, in denying requests to incorporate the evidence from the 2006 record as part of the record in this proceeding. The Secretary is requested to review, and rule on, the evidentiary requests.

(current), and the allowances that would result from using the CDFA and Cornell cost surveys, with reasonable extrapolation from best evidence available ('07 Proposed).

<u>Manufacturing Allowances per pound product</u>				
<u>Product</u>	<u>Original</u>	<u>'06 Proposed</u>	<u>Current</u>	<u>'07 Proposed</u>
Cheese	\$0.165	\$0.2077	\$0.1682	\$0.2154
Whey	\$0.159	\$0.2281	\$0.1956	\$0.2080
NFDM	\$0.140	\$0.1848	\$0.1570	\$0.1782
Butter	\$0.115	\$0.1554	\$0.1202	\$0.1725

In assessing the reasonableness of '07 proposed make allowances, we have made an effort to compare the size of plants reported in the several surveys against FMMO plant sizes as reflected in regional NASS data, publications of Dairy Programs and Federal Milk Market Administrators, rulemaking decisions of the Secretary, and our own experience. From this, a determination of what constitutes a “representative” FMMO plant or plant grouping can be made. Because surveyed costs are based on past information that is becoming stale with time, and may distort costs for specific regions, we have also referred to trends in input costs, and significant regional differences in input costs where information is available, as reflected in data published by the Bureau of Labor Statistics and the Department of Energy.¹³ We have also sought to exclude the smallest plants, with outlying high costs, in our assessment of “reasonable” cost recovery or “representative” plant size.

¹³ See BLS data: Industrial natural gas prices, PPI Series WPU0553; Industrial electric power prices, PPI series WPU0543; Boxes and containers prices, PPI series WPU091503; Specialty cleaning and sanitation product prices, PPI series WPU06720102; Unit labor costs for non-durable goods (an index that captures improved labor productivity and efficiency), PRS32006113; Department of Energy, EIA, Short Term Energy Outlook, <http://www.eia.doe.gov/emeu/steo/pub/contents.html> ; EIA regional electric prices, http://www.eia.doe.gov/cneaf/electricity/epm/table5_6_b.html ; EIA, Natural Gas Monthly, http://www.eia.doe.gov/oil_gas/natural_gas/data_publications/natural_gas_monthly/ngm.html ; and BLS, National Compensation Survey, Blue Collar Wages by Region.

On the basis of this record, “reasonable” costs for “representative” plants may be conservatively estimated. To arrive at costs for representative plants, however, reasonable extrapolation and inference from record evidence is required, particularly for cheese. The make allowances adopted should be no less than those described below.

(i) A Reasonable and Representative Current Make Allowance for Cheese is \$0.2154 per pound.

If the TFD approach is applied to this record, without any further test for size-bias or representativeness of plants in the survey sample, the Department would simply combine the Cornell 2007 weighted average cost of \$.1584 per pound, weighted by 1.305 billion pounds of surveyed plant volume with the CDFA average cost of \$.1914, weighted by 826.6 million pounds of production. The average plant size of the two surveys (CPDMP and CDFA) are compatible, Cornell at 118.7 million pounds of capacity compared to California’s average size of 118.1 million pounds. To the weighted average of the two surveys, \$.1712 per pound, USDA would continue to add the \$.0015 marketing allowance, producing an allowance of \$0.1727.

However, this clearly does not meet the regulatory objective of reasonable costs for representative plants, because cheese plants producing 118 million pounds of product per year are very, very few among the 53 cheddar cheese plants in the plant population that produce more than one million pounds of cheddar cheese annually. See Ex. 36, pp. 6-8. For cheese, more than any other product, the average plants in the surveys are clearly not “representative” plants. Department must therefore combine good cost data for these large plants with reasonable extrapolation methodologies to produce a regulated make allowance for representative plants. From data predominately reporting 2004-2005 plant costs, Dr. Stephenson estimated in 2006 that the average (median) plant produces about 10 million pounds of cheese at costs of about \$0.25 per pound. *Id.*, Fig. 1 and 2.

The most recent weighted average CPDMP and CDFA cost data, therefore, would be for plants that are 1,118 % of the size of a median cheddar cheese plant.

Perhaps, for policy purposes, the Secretary may decide that only plants producing 2 million, 5 million, or 10 million pounds of cheddar cheese or more should be included in the relevant plant population. At 10 million pounds, this would leave about 26 plants in the relevant population, with average production of approximately 70 million pounds (*id.*, Fig 1) and average make costs of just under \$0.20 per pound in 2005 (*id.*, Fig. 2).¹⁴ While we do not necessarily endorse this approach, use of costs for plants of 118 million pounds average production clearly do not meet any test of reasonableness for representative plants, even if the relevant plant population is floored at 10 million pounds production. This is because there is an undisputed “significant” difference in costs attributable to plant size alone. Further, it is also beyond dispute that cheddar cheese plant manufacturing costs have increased over time from data reported in 2006 to data reported in 2007. The “best evidence” of the amount of such increase from this record, for FMMO cheese plants, is 1.7 cents per pound. Ex. 72, p. 6; Stephenson, Tr. 2781.¹⁵

The conclusions from the foregoing test of reasonableness, applied to a constructed group of “representative” plants averaging 60 million pounds production, further corroborates the reasonableness of Dr. Stephenson’s weighted average estimate of 2005 costs of \$0.2028 per pound cheese for the larger population of 53 plants in the 2006 CPDMP survey. Ex. 36, p. 8. It is likewise consistent with the reported simple average cost of \$0.2065 per pound for 16 cheese plants, producing an average of about 60 million

¹⁴ These analyses are based on eyeball estimates from Figures 1 – 3 in Ex. 36.

¹⁵ It is anticipated that during or about December 2007, CDFA will release results from its audited surveys of manufacturing plant costs incurred during 2006. This publication, of which USDA may take official notice, will provide yet another tool to extrapolate FMMO plant costs and to test the reasonableness of inferences made from best available data in this record.

pounds of cheese in the 2006 CPDMP survey. Ex. 37 p. 7. It is also consistent with CDFA reports of average 2005 costs of \$0.1966 (adjusted to \$0.1981 with a marketing allowance) for a group of somewhat larger cheese plants averaging 84 million pounds annual production. For cheese plants on this record, these sources of evidence are part of the “best available” information from which representative FMMO cheese plant costs may be extrapolated.

Ultimately, rates for regulated make allowances, like any other regulated rates, are tested not by pinpoint precision to the mil and deci-mil as interested parties and agency decision-makers are inclined to do, but rather by an end result that fits in a zone of reasonableness when all relevant factors – particularly an end result that provides a genuine and reasonable return on investment to plants - are considered. *E.g., Permian Basin Area Rate Cases*, 390 U.S. 747, 768-89, 797 (1968); *Jersey Central Power & Light Co. v. FERC*, 810 F.2d 1168 (D.C. Cir. 1987) (en banc). But where reasonable return on investment is measured by pennies and mils, as it is for commodity dairy product manufacturers, the zone of reasonableness is limited. Use of the size-biased and otherwise unrepresentative costs for very large plants in the 2007 CPDMP survey (though undoubtedly credible for the sample surveyed), to fix make allowances for representative FMMO cheese plants, would clearly fall outside of the zone of reasonableness. Maintaining the existing make allowances, with ever-decreasing margins from which costs may be recovered, is also outside of the zone of reasonableness. *See also* discussion and tables on pp. 39-40, hereafter.

IDFA’s post-hearing brief uses a method for extrapolating from best evidence of record, and estimating make costs of \$0.2154 per pound for cheese plants. This method is also consistent in result with any number of other means by which a proposed make allowance may be tested for reasonableness. Like the Administrator’s approach to butter

plant make costs, IDFA's analysis for cheese manufacturing costs is one method, from limited information in this record, to "reinforce and improve estimating the cost of manufacturing [cheese] outside of California because no other better source of cost data is available on which such costs can be reasonably based." 71 Fed. Reg. at 67487.

IDFA's proposed allowance for cheese is, in our current opinion, just barely and arguably within the low end of a zone of reasonableness for a make allowance that will apply to cheese plants starting in 2008, or later. The Operating Cooperatives, therefore, endorse adoption of a cheddar cheese make allowance of \$0.2154/lb, as proposed by IDFA. Like other make allowances, this should be adopted expeditiously so we do not again have to hold another hearing before the allowance even takes effect.¹⁶

**(ii) A Reasonable and Representative Current
Make Allowance for Whey is \$0.2080**

In view of the great risks of overstating imputed whey revenue to cheese plants (fn. 11, *supra*), USDA cannot reasonably rely solely on large, low-cost whey plants in the Cornell survey as representing representative whey processing costs for FMMO cheese plants. USDA should combine the CDFA average cost of \$.2851, weighted by 107.0 million pounds of production with the Cornell weighted average cost of \$.1976 per pound, weighted by 942.1 million pounds of whey produced outside of California. To the weighted average of the two surveys, \$.2065 per pound, USDA should continue to add the \$.0015 marketing allowance. Even this recommendation, extrapolated from best evidence of record, produces a very conservative estimate of whey processing costs for the average cheese plant.

¹⁶ While this brief was in its final drafting stage, crude oil prices on the world market reached a new high, in excess of \$80 per barrel. This event, of which the Secretary may take official notice, illustrates just how quickly any cost component included in make allowances may become out of date.

(iii) A Reasonable and Representative Current Make Allowance for Butter is \$0.1725.

USDA should combine the CDFA weighted average butter cost of \$.1408 weighted by the 448.6 million pounds of production with the Cornell butter cost estimate of \$.1846, weighted by the 995.7 million pounds of product produced, outside of California. To the weighted average of the two surveys, \$.1710 per pound, USDA should continue to add the \$.0015 marketing allowance.

(iv) A Reasonable and Representative Current Make Allowance for NFDM is \$0.1782.

USDA should combine the CDFA average cost of medium-sized powder plants of \$.1872, weighted by 613.2 million pounds of production with the Cornell weighted average cost of \$.1662 per pound, weighted by 614.3 million pounds of NFDM, produced outside of California. To the weighted average of the two surveys, \$.1767 per pound, USDA should continue to add the \$.0015 marketing allowance.

C. Expedited or Emergency Decision-Making for Make Allowances.

In our Briefs following the 2006 Emergency Hearing, and Comments on the Tentative Decision, the Operating Cooperatives, singularly and collectively, argued that the Cornell costs for butter and powder were unrepresentative. We argued that the RBCS averages for those commodities were taken from a larger sample of plants and were more creditable. Comments on the rushed nature of the Cornell butter and powder surveys were submitted and, unlike the RBCS survey, respondents were not given the opportunity to check Cornell's results. Nevertheless, USDA relied on Cornell's Cost Survey to issue the manufacturing cost allowances contained in the TDF.

In his direct testimony of July 10, 2007, Dr. Stephenson noted that he misallocated costs at butter/powder plants in the Cornell Survey for the 2006 hearing. The 2006 Cornell Survey allocated too much cost to intermediate products (cream) at some plants and thus under-estimated the true cost of NFDM manufacture. (Exhibit 72) In his testimony the witness from Northwest Dairy Association (NDA) noted that his cooperative and Cornell had determined that manufacturing costs for NFDM were under-reported at the four powder plants owned by NDA. The NDA witness noted that the cooperative's portion of the 2006's NFDM volume was 55-percent and that the under-reporting of the NDA powder costs resulted in an under-reporting of the NFDM cost in the 2006 Cornell Survey by \$0.019 per pound. (Exhibit 73, pg. 7) Professor Stephenson noted in his cross examination that the \$0.019 was a "ballpark" estimate of the under-reporting of NFDM costs in the 2006 Cornell manufacturing cost survey.

At the 2006 Class Price and Make Allowance hearing, Professor Stephenson commented that he was uncomfortable with the butter manufacturing costs reported at the hearing. At this hearing, Dr. Stephenson noted that there are two things that an economist or statistician considers when determining whether the sample is representative of the population. He noted two measures of reliability: the first is the number of sample observations and the other is the measure of variability around the mean. (NT, 2758) While the number of sample observations, four, is the same for the 2005 and 2006 surveys, the average plant volume for the more recent butter survey is significantly larger. Regarding the variability issue, Dr Stephenson testified, "In my testimony on plant processing costs on September 14, 2006, I stated 'That the confidence interval for . . . butter ranges from -\$0.0921 to \$0.3905. The large range on butter costs reflects relatively few observations and a fair amount of variability in the data.'" While commenting that the reported butter costs in the more recent survey increased by more

than \$0.07 per pound, Dr. Stephenson further noted, “. . . I have much more confidence in the data this time.” (Exhibit 76)

Under cross examination Dr Stephenson noted that the variation in butter manufacturing costs was partially explained by the same misallocation of costs at butter/powder plants to intermediate (cream) products. He said:

- Q. What portion of overhead do you allocate to those intermediate solids? How did you do that?
- R. Well again, the problem that I had last time or what I will call a problem was that those were allocated based on pounds of solids that were in the products that left the plant, so if you had a lot of them going out in liquid form, they probably didn't incur very much cost, but I assigned a fairly high cost to them. (NT, 2828)

Summing up his confidence in his 2006 testimony, Dr. Stephenson said, “You know, after receiving the second set of information I have, as I said at the time, real concerns about that. I think that if I had known better, I guess at the time, I probably wouldn't have published the butter data at all.” (Tr. p. 2828).

The Secretary relied on the Cornell Survey of Manufacturing Costs to issue the make allowances and cost allowances contained in the TFD. Plainly, the author of the Survey finds it necessary to distance himself from the conclusions of the butter/powder cost survey. Without re-opening the 2006 Hearing, the revised testimony of the 2007 Hearing cannot be considered in a Final Decision of the 2006 Hearing. Corrections to make allowances adopted in the TFD for reasons of errors revealed on this record, therefore, must be made in a decision on this hearing.

The consistent standards of economics, policy and law expressed in make allowance decisions from 1999 through 2006, applied to substantial evidence of record in this proceeding, compel expedited amendment of manufacturing allowance rates in the

current milk product price formulas. This will stem the drain of unrecovered losses resulting from the 2006 mistakes. Therefore, the Operating Cooperatives respectfully request that the Secretary rectify the errors of fact contained in the 2006 Hearing and issue an Emergency Decision on Proposal 1 in an expedited fashion, without a Recommended Decision or at least with a separate and expedited recommended decision.

II. DETERMINING AND APPLYING CHANGES IN DAIRY PRODUCT MANUFACTURING COSTS IN THE FUTURE (Proposals 2, 17).

A. There is a Compelling Need to Provide for Periodic Automatic Adjustments in Make Allowances Due to Changes in Energy Costs.

Agri-Mark, et al., support NMPF's proposals and argument for make allowances to be automatically adjusted by an energy cost index. The cost of natural gas and other energy inputs is the largest source of non-labor costs in dairy product manufacturing, and the most volatile cost input. Energy costs may rise quickly, remain stable, or decline quickly for reasons beyond the control of manufacturers or USDA. The make allowance amendment process, on the other hand, is not a quick one. As proposed by NMPF, make allowances would be adjusted without hearing by changes in energy costs between hearings. Each make allowance hearing otherwise required to update make allowances will provide a fresh opportunity to refine the energy index formula, if needed.

B. There is a Compelling Need for USDA-Dairy Programs to Develop and Apply Reliable Standards and Procedures for Periodic Survey and Publication of Dairy Product Manufacturing Costs in Representative Plants.

Proponents of proposal #2 wish to limit their support to that part of it which seeks to grant authority to the offices of the Milk Market Administrators to conduct an annual (or periodic) survey of dairy plant manufacturing costs for cheese, whey powder, butter

and nonfat dry milk production located within the continental United States but outside of California. The Market Administrators would administer all aspects of the survey including selecting the sample plants so that they would be truly representative of the entire appropriate plant population as well as collect, assemble report and audit the cost information. This information could then be used as evidence to call a hearing and/or make changes in the related provisions of each Order.

Dr. Stephenson of Cornell University has already developed the methodology and computer-aided worksheets necessary to conduct such a survey. As noted already, the methodology is based upon CDFA work already being performed. CDFA should be able to give some guidance for the preparation, use and auditing of such a survey.

Proponents withdraw their request to use future manufacturing cost survey data to automatically update make allowance provisions of the Orders. While proponents also believe there is merit in using the two criteria in the original proposal to determine and facilitate future changes in make allowances, those criteria and other issues should be considered at future hearings once survey results are available and have been reviewed.

Updates of the manufacturing allowance provisions in Federal Order will certainly be needed to revise costs and keep net prices current. However the Cornell survey needs expansion of its survey size and distribution. In addition, updating costs can more reasonably be done after consideration of all factors, which would be more likely accomplished in the hearing process. This process follows CDFA's procedure. Despite CDFA's publications of annual cost surveys, that CDFA still holds a hearing before updating make allowances.

III. USE OF REPRESENTATIVE OR IMAGINARY MANUFACTURED PRODUCT YIELDS FROM PRODUCER MILK (Proposals 5, 6, 7 & 8)

The proponent of proposals 5 through 8 lament that USDA does not collect or audit data on plant yields. The proponents believe that plant yield for a cheese, butter, whey or NFDM plant is synonymous with the volume of product that can be processed into a finished product from a hundred pounds of producer milk. For instance, proponents cite the average vat yield from CDFA cheese cost surveys, and the cheese volume noted in the 2006 Rural Business Cooperative Service (RBCS) survey, as evidence that the Class III formula should reflect these plant yields. While the RBCS survey did not elaborate on the composition of milk and other dairy products in the vat, the CDFA survey makes it clear that skim condensed milk, NFDM and/or milk protein concentrate from ultra-filtered milk is commonly added to cheese vats. Reported plant (vat) cheese yield is therefore not representative of the volume of cheese that can be produced from a hundredweight of milk.

The witness representing Dairy Producers of New Mexico had an enlightening dialogue during cross-examination regarding his understanding of product yields and how yields should impact the class price formulas. (Tr. p. 2285-94). The witness was asked a question regarding the introduction of semi-finished products into the cheese process

- Q. In order to convert that to a producer price, you have to make some adjustment for the difference in yield with those added solids and try to figure out what the yield might be without the added solids?
- R. I don't know – you, Mr. Vetne, I don't know that I agree to that. You're adding a level of complexity of trying to understand what needs to be done. . (Tr., p. 2286)

Later in the cross examination the witness states:

. . . (T)he point of it is, if on the average the milk that comes in from the farm at the front of the silo and the cheese that goes out on the dock, whatever that yield is, that's what we're going to use.

However the plant got there, whatever they added, you know solids or cream or dust, I don't care. What we need to be looking at is how do we get

there? That's what I was trying to get us to look at a bigger thing like (Exhibit) 34A, rather than getting down focused on this minutia of whether the ratio of purchased solids versus acquired solids for milk is this, or we buy cream or anything. It doesn't get us anywhere.

That producer milk, based on whatever technology the plant uses, whatever products it buys to make it work, a pound of producer milk going in that plants is going to yield so much cheese at the other end, and that's what counts. If they buy solids, who cares? (Tr. pp. 2288-9)

The witness advanced a theory that USDA should not attempt to determine the volume of products that can processed from a hundredweight of milk, but to determine the pounds of products that are manufactured from the silo or vat of ingredients in a butter/powder, cheese or whey plant, without accounting for the intermediate products introduced into the process. To make the issue clear, powder plants often will buy skim condensed milk from outside milk condensing plants to introduce into the powder drying process. The addition of these outside-purchased milk solids enhances the volume of powder produced from the plant, relative to the producer milk purchased. Following the proponents' theory, the Class IV price formula should recognize the enhanced powder production by increasing the yield component to the formula. It makes no economic sense, however, to price farm milk based on a plant yield includes added milk and dairy ingredients.

Additionally, the witness asserts that dairy farmers are paying for costs of plant equipment, designed to increase yields, through make allowances. He states that the “. . . equipment, management, payroll (and) packaging” costs ascribed to plant yield enhancements are paid for through reduced income. (Tr., p. 2289) Actually, Professor Stephenson noted in answer to a question that producers already benefit from enhanced yields, because the average manufacturing costs are derived by dividing the total costs by pounds of products produced.

Q. If there was a plant that got yields greater than the yields assumed in the formula, that would mean that in the scenario that you just put out would be increasing the (divisor), so they would have more pounds out than the standard; would that be correct?

R. More total pounds, yes.

Q. As a result the per unit cost would go down?

R. That's correct. If the divisor is larger, then the per unit costs are going to be smaller.

Professor Stephenson concluded, "Yes, sure, if you had more pounds of total product, it would make a smaller allowance." (Tr. pg 2637-8)

Proposals 6 and 8 would increase the formula yields for butter, powder and cheese. Additionally, proponents would eliminate any recognition, in the product yields, for farm to plant losses of butterfat and nonfat skim solids. The result of all of these proposals is a reduction in handler cost recovery to artificially increase in class prices. Without offering anyone with plant experience and qualified to testify on plant yields, the witness representing The Dairy Producers of New Mexico asserts:

If the current yields were too high for any processor, let alone ones of average efficiency, there would be requests to lower the yields. Since there are no such complaints it means that the yields are below the lowest yielding plants! Otherwise, we would expect complaints from processors similar to those made regarding make allowances. (Exhibit 32, pg.27)

The other right answer, of course, is that the yield formulas, developed by the Department through the Federal Order Reform process and the 2000 Class III and IV Hearing, adequately describe the representative volume of finished product processed from a hundred weight of producer milk.

Proponents of higher imputed fat recovery in cheddar cheese argue that whey cream can be recycled back to the cheese vat, resulting in a bit more fat from producer milk ending up in cheese. However, the use of recycled whey cream in cheddar vats is a

practice of few manufacturers, and commodity cheddar cheese produced by this method represents a small portion of commercial cheddar cheese. Many witnesses at the hearing testified that they do not recycle whey cream through their vats due to inferior product quality, unacceptability to customers, increased manufacturing costs, lower finished product value,¹⁷ and other reasons. E.g., Agri-Mark, a (Tr., pg. 857), Twin County Dairy (Tr., pg. 1411), Foremost Farms (Tr., pg. 1542), Davisco (Tr., pg. 1570), Great Lakes Cheese (Tr., pg. 1919), and Land O'Lakes (Tr, pg. 2115). Witness Sommer from the University of Wisconsin Center for Dairy Research testified that Alto Dairy did not do so and that it was an unwise practice (Tr, pg. 2350). Even where whey cream is recycled, fat recovered in cheese from whey cream is significantly lower than from fresh cream. The witness from NDA commented on the practical limitations to the reintroduction of whey cream into vats, including significantly lower fat recovery (75%), softer curds, and customer considerations (Tr, pg. 2561-2562). The witness from Kraft, the largest retail marketer of cheese in the U. S., testified that Kraft allows the use of whey cream in only between 10 to 15 percent of the total cheese that they buy (Tr, pg. 1102).

Relying on isolated vat yield data, the supporters of Proposal 6 assert that the butterfat retention factor in cheddar cheese be changed from the current 90-percent to 94-percent. Irrespective of their admission that CDEA vat yields are not equivalent to yields from producer milk (Exhibit 32, pg. 36), the supporters' only evidence for their proposal

¹⁷ Due to added labor and non-labor processing costs associated with recycled whey cream, and limited market demand for cheddar made with recycled whey cream, it may be necessary to develop a separate cost survey for plants using recycled whey cream, and a separate price series to reveal accurate values for this cheddar sub-category, in order to accurately measure how much (if any) the value of extra fat recovery exceeds the greater processing costs and lower average market prices for the product. One thing that would be plainly arbitrary – and what proponents urge – is to attribute to all cheddar cheese produced greater fat recovery from whey cream, when this is clearly not the case, and then pretend that recycling whey cream comes without additional costs and without lower finished product market demand and consequent lower product prices.

are extrapolations from reported CDFA cheese yields. Opposition to the proposed change in the assumed butterfat retention percentage came from the expert testimony of Dean Sommer (Tr. 2239), the plant experiences of Foremost Dairy (Tr, 1528), Land O'Lakes Exhibit 55, pg.4), and Davisco (Tr, pg. 1591). Regarding the butterfat yield "correction," described in Proposal 6, if the Secretary made an error in 2003, it should be rectified in light of the current evidence regarding farm to plant losses.

Proposal 8 recommends that the NFDM yield be increased from 99-percent to 102-percent, but suffers the same lack of supporting record evidence to merit serious consideration by USDA. Proponents' only evidence offered are copies of two reports (Exhibit 33, XXX and YYY) that were also offered in the 2000 Class Price hearing. Originally Federal Order Reform set the NFDM yield at 98.03-percent (reciprocal of divide by 1.02). In 2001, the Tentative Decision eliminated the credit for buttermilk solids and set the NFDM yield at 100-percent. (66 Fed Reg. at 76843). Again the Department took up the issue in the 2002 Final Decision and wrote a fully reasoned decision that addressed the effects buttermilk solids. (67 Fed. Reg. at 67921-2). The Secretary also recognized farm to plant losses and correctly adjusted the NFDM yield to recognize those losses in the class price formulas.

In the course of Federal Order Reform and later hearings, the Department has addressed NFDM yields at least three times. Supporters of Proposal 8 provide no new evidence, and only offer the same arguments from the 2000 Hearing. Operating Cooperatives recommend that USDA find that proponents have not met their burden of proof under 5 U.S.C. §556(d) to merit further consideration of the proposal.

The Dairy Producers of New Mexico also propose that USDA change the yield formulas of butter powder, cheese and whey by eliminating the allowance for farm to plant losses. The fact that milk solids are lost between the measurement at the dairy farm

and the milk plant is not in dispute. Testimony was offered by Michigan Milk Producers (Exhibit 13, pg. 2), Land O'Lakes (Exhibit 56, pg 3) and Leprino Foods (Exhibit 69, pg. 21) quantifying those losses.

The dairy farmer supporters of Proposal 7 make far more milk per day than the average dairy farmer, and commonly fill a 48,000 pound tank truck with one farm pick up. They are not representative of the average dairy farmer pooled on the federal orders. In 2006 the average daily production of farmers pooled on the orders was 6,264 pounds per day. Clearly the national marketing norm is to combine and co-mingle several dairy farmers' production on a milk truck. Moreover, the national norm is to invoice the dairy plant based on producers' weights and tests.

In the 2002 Final Decision (67 Fed. Reg. at 67917) the Secretary found that farm to plant losses are "real, unavoidable and common" and that "milk unrecoverable in the movement from farm to plant cannot yield finished product." The Secretary further found that an adjustment to the yield co-efficient of the class formulas was appropriate in order to compensate manufacturers for these losses, and to avoid charging manufacturers for phantom milk product sales. The supporters of Proposal 8 provided no evidence to contradict the Secretary's 2003 decision. Proposal 8, therefore, should be rejected.

IV. COMMODITY MARKET PRICES THAT FAIRLY REFLECT THE VALUE OF MILK IN MANUFACTURED PRODUCTS INCLUDED IN THE CLASS III AND CLASS IV PRODUCT PRICE FORMULAS (Proposals 4, 9, 10, 11, 12, 13, 14, 15, and 20).

A. Subject to Possible Adjustment to Reduce the Time Lag Between Transactions and Reports (Proposal 14), The NASS Survey Prices Should Continue to be Used as Market Price References for Cheddar Cheese, Butter, Nonfat Dry Milk and Dry Whey Used in Class III and IV Product Price Formulas.

Proposal 14 advocated by Agri-Mark seeks to amend the Class III protein price formula by using a combination of the weekly NASS and CME cheese price series to determine a hybrid cheese price to be used in that pricing formula for both Class I and Class III price purposes.¹⁸

This proposal combines the weekly NASS and CME cheese price series to determine a hybrid price series that reflects cheese market price movements on a timelier basis, duplicates the average value of the NASS price series over time, and reduces the volatility of the producer price differential.

U.S. cheese manufacturers use the CME market prices as a basis to set their cheese prices. However, USDA uses the NASS cheese price survey to determine the cheese prices that in turn are used to determine Class III prices each month. While the NASS and CME are closely linked, that relationship usually involves a two week difference. The two-week difference between NASS and CME prices became a serious problem in 2004 when CME cheese prices changed so quickly from week to week that the monthly average between the two price series fluctuated dramatically. In fact, the two prices varied by more than \$.10 per pound in seven of the 12 months of 2004.

Exhibit 35 showed the simple regression results estimating the relationship between the NASS and the CME. The exhibit shows the relationships based on having no time difference as well as one week, two weeks and three week differences. The time period from the beginning of 2003 to early September 2006 was used. As seen in the exhibit, a two week difference in the CME relative to NASS prices shows the best relationship. In fact, during the 193 week period, the CME explained 98.5% of the variation in the NASS.

¹⁸ Proposal 14 is advocated by Agri-Mark. The other Operating Cooperatives represented in this Brief acknowledge the problem the proposal is designed to address.

NASS VS CME WEEKLY CHEESE PRICES RELATIONSHIPS REGRESSION ANALYSIS : R Squared Values	
	JAN 4, 2003 - SEPT 9, 2006
CURRENT NASS VS CME	88.3%
1 WEEK DIFFERENCE NASS VS CME	96.9%
2 WEEK DIFFERENCE NASS VS CME	98.5%
3 WEEK DIFFERENCE NASS VS CME	93.1%

source: CME NASS ANALYSIS REGRESSION SEPT 30 O6.123

Also included in Exhibit 35 was a chart that showed the weekly time line for the monthly cheese price used in the Class III and Class I price calculations, with illustrations for April.



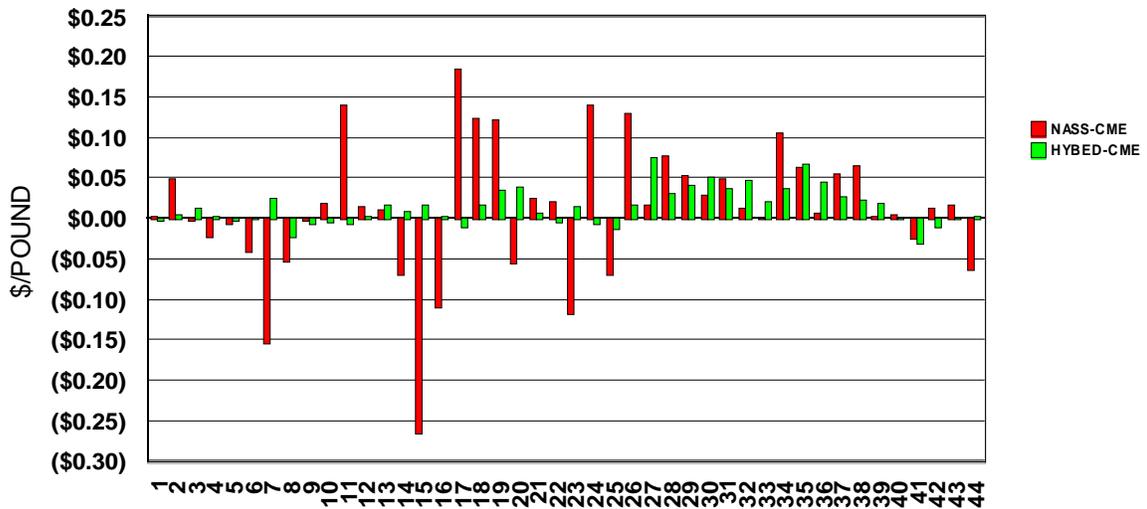
The proposal uses the actual CME weekly prices for April adjusted by the difference between the NASS cheese prices for the last two weeks of March/first two weeks of April and the CME cheese prices for the four weeks of March. This adjusted CME price is referred to as the Hybrid Price.

This proposal essentially uses all the weekly observations of all NASS and CME prices. Over a number of months, the CME current month price series and the previous month CME prices series cancel one another out, leaving only the NASS price series as the average price indicator overtime. Proposal 14 allows the USDA to use up-to-date CME prices needed by the industry while making the appropriate adjustment in those prices to assure that the NASS price is the ultimate determinant of cheese prices used over time. If the CME is manipulated in such a way as to diverge from true NASS prices, this proposal automatically adjusts those CME prices to the actual NASS prices to correct the situation.

The second half of the time line chart in Exhibit 35 shows how the cheese prices for the Class I price determination can also be changed to use the more current CME price series, while also adjusting back to NASS prices. This part of the proposal allows the use of actual CME prices for the second and third weeks of March to determine the Class I cheese price, instead of the current first two weeks of NASS pricing. This part of the proposal does use a different set of weeks than currently used, so it may not come back to the specific NASS prices on a historical basis. However, it does maintain an appropriate relationship to the NASS price series.

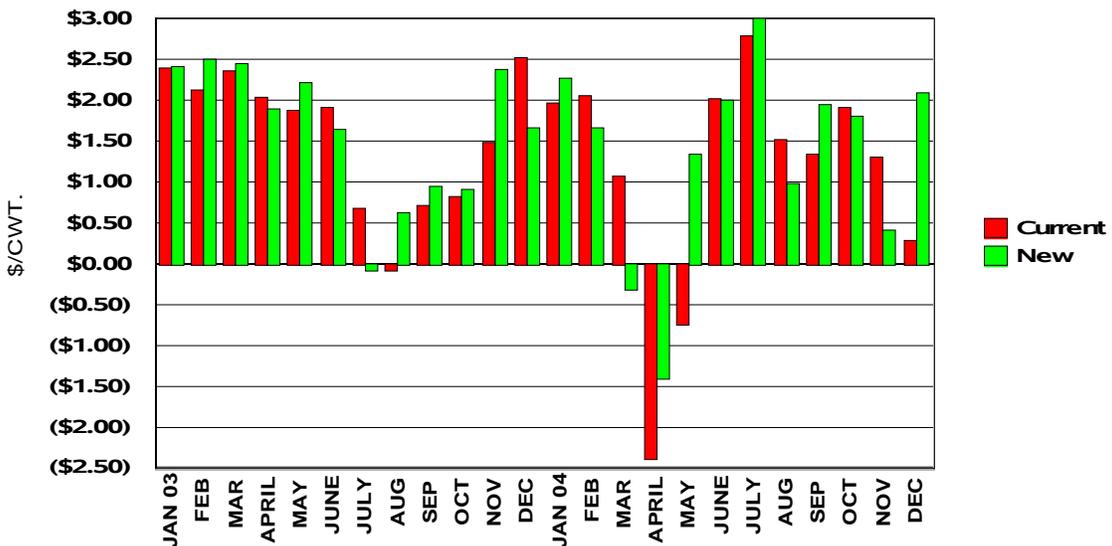
The graph in Exhibit 35 entitled “MONTHLY DIFFERENCES BETWEEN NASS AND CME CHEESE PRICE VERSUS HYBRID AND CME PRICES, JAN 2003-AUG 2004”, shows the current volatility in NASS versus CME cheese price. These are the darker (or red in the color version) bars. The proposed hybrid cheese price (the CME adjusted by the NASS/CME difference) compared with the CME is shown as grey (or green in the color version). This type of volatility would be reduced significantly under proposal 14.

**MONTHLY DIFFERENCES BETWEEN NASS AND CME CHEESE PRICES
VERSUS HYBRED AND CME CHEESE PRICES, JAN 2003-SEP 2006**



This proposal has a second advantage in addition to better lining up CME and Federal Order prices. By using more current prices, particularly in the Class I price calculation, it also reduces the negative Producer Price Differentials experienced in 2004. The Exhibit 14 graph showed this for the 2003-2004 Northeast PPD:

NORTHEAST PRODUCER PRICE DIFFERENTIAL, 2003-2004



Two tables in Exhibit 35 compare the current and proposed Hybrid Class III cheese prices. The first table shows the “COMPARISONS BETWEEN NASS, CME AND PROPOSED HYBRID CHEESE PRICES” from January 2003 through August 2006. Over that 44 month period, the NASS and CME price series differed by \$.011 per pound on average, but had large variations from month to month. The Hybrid Class III cheese price proposed differed from the CME by \$.014, and therefore was within \$.003 of the NASS, AND it also eliminated much of the variation between the monthly CME and NASS prices.

The second table shows the impact of the new proposal on Class I, III and Northeast Blend prices as well as Producer Price Differentials (PPDs). The proposal did increase the Class I prices in both 2003 and 2004, but that was due to the weekly price movements in both years. There is nothing inherent in the proposal that would increase or decrease the Class I price. The Class III price was almost the same in 2003, but \$.15 lower in 2004. The 2004 average difference was caused by the December 2004 decline in CME cheese prices which was reflected in the proposed Class III cheese prices, but was delayed until January 2005 under current pricing.

Once again, there is nothing inherent in the proposal that would raise or lower average Class III prices over time. The PPD and Blend prices may both rise under the proposal, but each is driven mostly by somewhat higher Class I prices for the months observed. There is nothing inherent that would raise or lower average PPD's or blend prices over time.

Proposal 14 would address the current CME versus NASS monthly price distortion, while assuring producers that the current NASS price series would be the primary indicator of cheese prices over time. This is a win-win for both cheese

manufacturers under the Federal Orders and producers. In addition, it will do no harm to other Class prices and other manufacturers. We support amending the Orders to include the changes proposed in Proposal 14.

Except for consideration of time-lag problems addressed in Proposal 14, the NASS surveys should continue to serve as the source of commodity milk product prices.

No evidence was presented at the Hearing that would dispute the conclusion of the Final Decision (67 Fed. Reg. at 67913) where the Secretary found the NASS survey was “the best method of obtaining reliable data about commodity prices.” The witness, representing Land O’Lakes, presented evidence that compared the volume represented in NASS transactions with the volumes represented by CME transactions during 2005. Sales across the CME represented less than 8-percent of NASS cheddar block transactions, less than 2-percent of the NASS cheddar barrel and less than 1-percent of the NFDM transactions. In 2005 CME butter sales equaled 38-percent of the NASS sales transactions. The CME continues to be a thinly traded local market.

Operating Cooperatives recommend that USDA deny Proposal 15.

**B. The NASS Survey Should Capture all Relevant Transactions.
Proposal No. 20 Would Distort Reported Prices and Create Inequity
Among Manufacturers.**

Since Federal Order Reform in 2000, USDA has used product price formulas to set dairy class prices. NASS surveys the butter, NFDM, cheddar cheese and whey powder markets each week to determine the quantity sold and its price. Periodically USDA will hold hearings and take evidence regarding the manufacturing cost of converting milk into the priced commodities. So that processors are not unduly compensated through a regulatory system, USDA determines its make allowances by calculating the weighted average cost from a sample of representative processors. USDA

further protects farmer interests by weighting the survey of Federal order plants with the CDFA survey. This weighting-on-weighting process skews manufacturing costs and makes allowances towards those costs experienced by the larger plants.

Proposal 20 would further complicate the pricing system by requiring manufacturers to recover their USDA-certified cost increases only through increasing their product prices. The proponent would have the Department believe that a manufacturer could increase the market price of its commodity butter, NFDM, cheddar cheese or whey by merely showing its customer that USDA has certified that the cost of manufacture has increased from a base period. Manufacturers, who itemize a cost surcharge equal to or less than the make allowance adjustment granted by USDA, can refrain from reporting the permitted surcharge in their NASS weekly price reports.

Product manufacturers would be able to recoup the cost increases if and only if, they and all product manufactures, including processors in unregulated areas, collectively increase their prices by the USDA-certified amount and the increases are labeled on the sales invoice as a surcharge. If only one surveyed manufacturer can not increase his price or does not correctly label the increase on the sales invoice, then that sale will impact the weighted average NASS price for all manufacturers. As noted at the Hearing there is no incentive for manufacturers located in California, or any other unregulated area, to comply with the provisions of Proposal 20 because the NASS price has no impact on their milk cost. Additionally, it was never clear from hearing testimony that product sales across the Chicago Mercantile Exchange or to the Commodity Credit Corporation would be able to reflect USDA-certified cost surcharges.

At best, if all processors were to pass on a USDA-certified cost increase to their customers, class prices and producer prices would decrease to the same level as projected by proposals in this hearing, not through an increase in make allowances, but through

lower NASS prices. The resulting improved cost recovery in margins between class prices and commodity prices would simply not be as visible as “make allowances.” At worst, processors would not pass on the increases to their customers and would find no relief for manufacturing cost increases.

The Operating Cooperatives request that USDA reject Proposal 20.

C. The Cheddar Cheese Block – Barrel Price Spread Used in the Current Formula Distorts Cheese Values and Should be Eliminated.

The artificial 3-cent adjustment for block cheese versus barrel cheese incorporated in the product price formula should be eliminated. Overwhelming record evidence reveals that it distorts reasonable inferences of cheese commodity values and of the value of components in producer milk used to make cheese.

The Operating Cooperatives endorse IDFA Proposal No. 12, and defer to IDFA’s hearing testimony and supporting post-hearing brief. We will not address Proposal No. 11, which deals with the same problem, but less effectively.

D. The Lower Value of Butterfat in Whey Butter Must be Reflected in the Product Price Formula.

The Operating Cooperatives support IDFA Proposal 9, which seeks to amend the Class III protein price formula to reflect the lower value of whey cream.¹⁹

The current Class III pricing formula recognizes that 10 percent of the cream in producer milk is not captured in cheese, but does not acknowledge this excess butterfat, known as whey cream, has a significantly lower value than butterfat fresh Grade A cream.

¹⁹ Agri-Mark’s Proposal 10, on this same issue, has been withdrawn.

The overwhelming evidence of record requires two adjustments to the protein formula, outlined by the witness from Leprino Foods, to offset or correct the current over-valuation of whey cream in the Class III price, as follows:

$$\begin{aligned} & \text{"}1.383 \times (\text{NASS cheese price} - \$0.1682) + [1.572 \times (\text{NASS cheese price} - \\ & \quad \$0.1682) - \\ & (0.922 \times \text{Fat Component Price}) - \$0.016] \times 1.17\text{"} \end{aligned}$$

(Tr., pg. 2471-2472; Exhibit. 69, pg. 16)

The current Class III protein price formula takes the following form (see http://www.ams.usda.gov/dyfmom/mib/price_form_2007.htm):

$$\begin{aligned} & ((\text{Cheese price} - 0.1682) \times 1.383) + (((\text{Cheese price} - 0.1682) \times 1.572) - \\ & \text{Butterfat price} \times 0.9) \times 1.17). \end{aligned}$$

The protein formula needs to be adjusted to reflect the true value of whey cream for several reasons related to both price and yields.

Butterfat in cheese and in whey cream does not represent 100% of butterfat found in incoming producer milk. Some fat is not recovered in the form of cheese or in whey cream. The witness from Leprino Foods testified how the net whey cream recovery equals 7.8% of the original cream in farm milk (Tr. pg. 2465-2468, Ex 69 p. 14). The witness from Kraft also recognized that some butterfat from the whey stream also ends up in whey (Tr. p. 1103). Some fat in the whey stream simply adheres to processing surfaces. Adjusting the fat component price factor from 0.9 to 0.922 reflects the actual whey cream yield of 7.8%, versus 10% currently found in the formula.

Whey cream is sold at significantly lower prices than fresh Grade A cream, and the price differences have widened in the past few years as the number of buyers has decreased. That butterfat in whey cream has significantly lower value than butterfat in

sweet cream was universally demonstrated by hearing witnesses, and rebutted by no one. The witness representing Leprino Foods stated that based on 2004-2004 prices, “the regulated minimum price under the current formula is based upon the assumption that processors are receiving in the marketplace 12.5 cents in the Northeast and 20.4 cents in the Pacific Northwest more than they really are, with respect to the fat component of the whey cream” (Tr, pg. 2460). The witness representing NDA outlined the company’s personal experience with whey cream pricing, noting that for the Cooperative’s fiscal years 2005-2007, “the price we received for whey cream on a butterfat basis averaged 47.4 cents lower than sweet cream and 24.4 cents below the Federal Order Class III butter fat price” (Tr, pg. 2554). The Leprino Foods witness uses the 2005-06 difference between the whey butterfat the federal order butterfat price to derive the 1.6 cent adjustment to the butterfat portion of the Class III protein price formula:

“This 20.4 cents per pound on the remaining 0.2715 pounds (7.8 percent of original fat) that we have determined is recoverable as whey cream, at a maximum, equates to a reduction of 5.5 cents per hundredweight. For consistency, this adjustment should be effectuated in the fat value correction portion of the protein formula. Since there are 2.9915 pounds protein assumed in a hundredweight of milk and the fat correction portion of the formula is multiplied by 1.17, effectively grossing up the fat adjustment to 3.5 pounds of fat, the appropriate adjustment to the fat portion of the protein formula is 1.6 cents. The 1.6 cents multiplied by 1.17 and 2.9915 equates to the 5.5 cents per hundredweight that needs to be adjusted” (NT pg. 2470-2471).

Low fat value in whey cream is a market reality that USDA’s Class III product price formula can no longer rationally disregard. Proposal 9 should be adopted.

V. COMMENTS ON NATIONAL ALL-JERSEY’S PROPOSAL 16.

The operating cooperatives do not support the Proposal from National All Jersey published in the Hearing notice, and presented at the April 10 hearing day in

Indianapolis. However, the operating cooperatives do support USDA collection of manufacturing cost and price data for WPC 34 and lactose, as outlined by the NAJ witness in his July 9 hearing appearance.

Proposal 16, as published in the hearing notice, would assign the whey value currently assigned to other solids entirely to the protein component of milk. But the NAJ witness acknowledged that dry whey contains about 13% protein, while the remainder consists of lactose and ash. The witness also acknowledged no know standard of identity for whey.

Because whey is not standardized for protein content and has no protein standard, adoption of this proposal could result in significant over-valuing of milk protein in relation to its contribution to whey values. The witness from Leprino Foods noted the problem pricing a component that has no direct yield impact on the final product: “the proposal shifts the value from a product whose yield is driven largely by one component , lactose and other solids , to a different component , protein . Since the lactose variability in milk is much lower than the protein variability in milk, this transfer will not equate with manufacturing economics at certain milk component levels” (Tr. pg. 2499). The Leprino witness then notes the shift of whey value to protein is “driven by the shift of a product to a component whose yield does not relate directly to that product, specifically protein” (Tr., pg 2499-250).

The operating cooperatives do support NAJ’s proposal to include 34% whey protein concentrate and lactose in future manufacturing cost surveys, as well as in future NASS dairy product price surveys. The NAJ witness testified on July 9 in regards to collecting manufacturing cost and price data on WPC and lactose, stating that “National All Jersey Incorporated seeks to expand Proposal 2 submitted by Agri-Mark to include

the products of whey protein concentrate and lactose in the annual manufacturing cost surveys should Proposal 2 be enacted by the Secretary” (Tr. pg. 2526). The witness from NAJ further proposed “that the weekly National Agricultural Statistics Service, NASS, dairy product price surveys be expanded to include whey protein concentrates and lactose (Tr. pg. 2527).

The NAJ witness noted that “Several witnesses at the two previous sessions of this hearing have testified to the profitability challenges being experienced by cheese plants given the extraordinary increase in dry whey prices since last fall, combined with the fact that dry whey prices no longer serve as an equitable proxy for whey protein concentrate values . Many of these same witnesses have requested that "something " be done about whey valuations In the Class III price formula.” (Tr. pg. 2526) “By building a data set of NASS prices for WPC's and lactose , the industry will be better equipped in the future to submit and debate proposals on how to include these products in price formulas to value whey solids other than only using dry whey” (Tr. pg. 2527-2528).

VI. COMMENTS ON DAIRY PROGRAM’S ECONOMIC ANALYSIS OF PROPOSALS, ON PROPOSAL 18, AND ON PUBLIC PERCEPTIONS ABOUT THE EFFECT OF REGULATED MAKE ALLOWANCES COMPARED TO “COMPETITIVE PRICES” ON FARM INCOME.

Much of the media attention, debate, controversy and litigation over make allowances in the 2006 emergency hearing, and in the broader Class III/IV product price formula issues in this proceeding, stem from a perception that USDA’s post-reform Class III-IV product price formulas (especially make allowances) diverts money from producer pockets to the pockets of dairy product manufacturers. Some witnesses pined nostalgically for pre-reform competitive Class III pricing when this did not occur, and Proposal 18 seeks a return to the perceived benefits of competitive milk pricing.

The very real perception that pre-reform competitive prices did not account for plant manufacturing costs, or provide other assurance of a reasonable margin including return on investment for plants, is erroneous. Throughout the decades leading up to federal milk order reform in 1999, “the manufacturer’s make allowance [was], in effect, ... deducted from the prices received from the sale of manufactured products before the pay prices” to producers were reported and employed as the Class III price. 64 Fed Reg. at 16097 (final FMMO Reform Decision); 60 Fed. Reg. 7290, 7299 (Feb. 7, 1995)(Final BFP Decision). The pre-reform deduction for manufacturing margins was made in a purely competitive environment. Competition, as described more fully in the Final BFP decision, and experienced by almost every industry, can be a harsh disciplinarian.

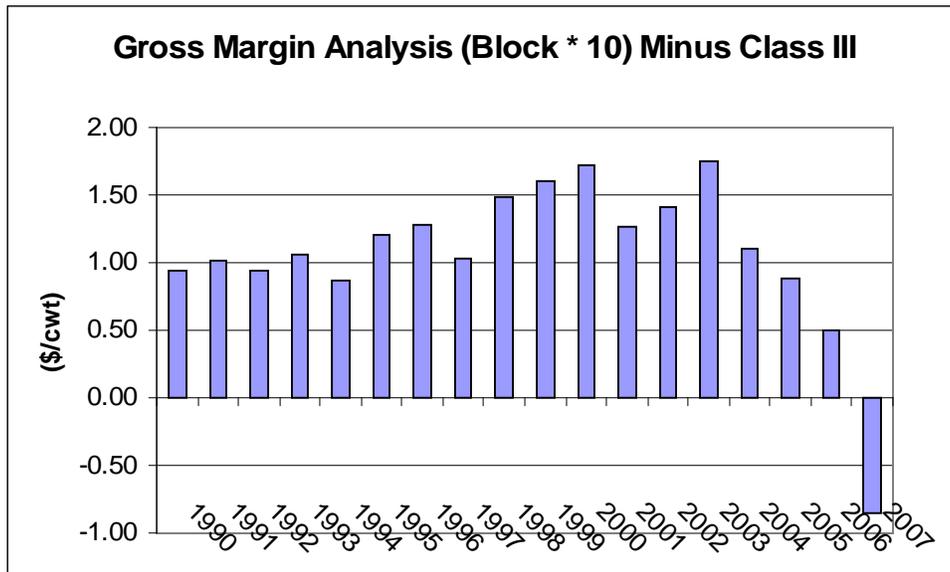
One thing that has changed greatly since the return to product price formulas in 1999 is that the manufacturing margins (now regulated, previously imputed) have been made very visible by their incorporation in the formulas. This new visibility is the source of perception that make allowances should be reduced, or at least not increased, to restore producers’ share of dairy product revenue to good old pre-reform levels.

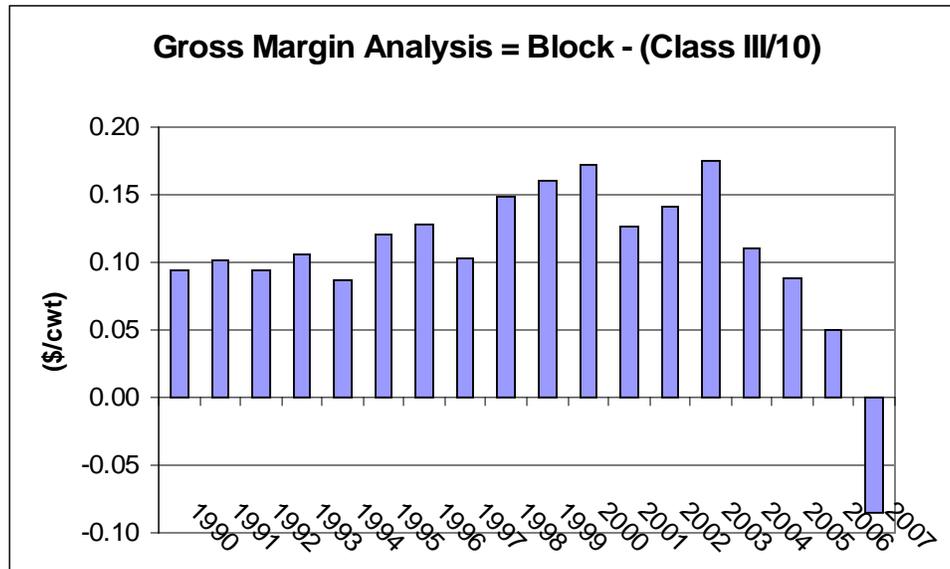
However, a simple comparison of plant margins as imputed for the pre-reform period and as limited by regulation in the post-reform period, reveals that regulation is a harsher mistress than competition, and manufacturing plants are increasingly unable to recover costs, much less any return on investment.

A Gross Margin Analysis over time can be done a per cwt basis or a per pound cheese basis. The concept is simple. Based on the cheddar block price as reported by the CME (and NCE before 1997) and regulated Class III prices, both of which are published in USDA’s weekly Dairy Market News,²⁰ what can a manufacturer afford to pay for milk, or what is the gross profit per pound of cheese after paying for milk? An *ad hoc* cost

²⁰ To the extent these published data are not already part of the record, official notice is requested.

benchmark for a cheese plant in the following tables may be illustrated by either \$1.00 per cwt or \$0.10 per pound of cheese. In other words if the CME block price was \$1.50 ($\$1.50 * 10$) = \$15.00, a manufacturer could “afford” to pay \$14.00/cwt. While this does not reflect the precise dollar value of margins imputed by NASS cheese price surveys, there is an established high correlation between NASS survey prices and cheese exchange prices. The analysis, therefore, provides a very good proxy for making conclusions about cost recovery trends, and the degree to which regulated make allowances have reflected (or distorted) actual manufacturing costs since competitive Class III milk prices were discontinued after 1999.





The Tables above illustrate that the gross margin has fluctuated over the years. Through the decade of the 1990's the gross margin for exchange price cheddar blocks increased from slightly less than \$0.10/lb. to \$0.16/lb. in 1999, the last year that some form of a competitive pay price was used to calculate the class III price. Since the implementation of a straight product formula price in 2000, with fixed make allowances, cheese manufacturers have experienced eroding gross margins on an annualized basis, and negative margins over the first eight months of 2007. This is due to the product-formula-driven class III prices rising more rapidly than CME block cheese prices. The class III price was heavily enhanced by a rising whey market in 2007 that severely disadvantaged cheese manufacturers that did not produce dry whey powder.

This analysis also reinforces the Operating Cooperatives conclusions that make allowances need to be updated to reflect increased manufacturing costs, just as the pre-reform imputed make allowance would have been increased to reflect increased costs. The necessary corrections will, as reflected in Dairy Programs' economic analyses of the proposals, necessarily reduce average class and blend prices. This, however, would be a

restoration to the approximate levels of such prices under competitive conditions (to the extent competitive factors influencing the old M-W price can be captured in regulated product price formulas). The corrections would also serve to restore equity between producers belonging to operating cooperatives, who have borne the losses from inadequate make allowances, and producers without significant investment in manufacturing plants, who have enjoyed a revenue windfall at the expense of their fellow producers and at the expense of manufacturing plants unable to recover costs. Producer milk prices, over time, reflect a competitive equilibrium so that available market supply is sufficient to meet market demand for milk and its products. As projected in Dairy Programs' economic analyses, any depression of milk prices caused by restoring make allowances to cost-recovery levels will likewise, over time, be tempered or mitigated by forces of supply and demand equilibrium.

The Operating Cooperatives oppose proposal 18 at this time. While we recognize that there are problems with using end-product pricing to determine Class prices under Federal orders, and a better alternative method may exist, we are concerned with enacting this specific method proposed without having any experience or knowledge of what the factor proposed will be or how it will affect the Class price series. The proposal is also very general and contains too few specifics for adequate consideration.

The primary witness in support of this proposal, Paul Christ, admitted that this proposal would only work if certain areas of the country using Federal order pooled milk be intentionally deregulated without the consent of the producers involved. We would oppose this action and would certainly not want it to apply to any area with members of our cooperatives.

We would suggest that USDA could consider developing a competitive milk price series so long as it was possible for the milk to remain independent from, and not

influenced by, Federal or state order minimum milk pricing. The price series could include competitive set milk prices in unregulated areas only, for example, if area milk prices are not influenced by the presence of FMMO pooled producers.. Once the price series is set up and information collected over a representative period of time, the results can be viewed by the industry and analyzed by USDA to determine if it should be used to fix or even influence minimum Class prices under the Orders. If the industry and USDA were convinced and some parties desired such a change, a hearing could be held at that time to consider it.

CONCLUSIONS

The basic policies and economic theories underlying prior USDA decisions on product price formulas as successors to M-W pricing for milk used in manufactured dairy products continue to be sound, and such policies should apply in this proceeding and in the future. As summarized in the foregoing brief, however, the FMMO product price formulas used to establish regulated Class III and IV milk prices should be updated to reflect current manufacturing costs, to correspond better with established policy, and to correct for distortions in imputed milk value from the sale of finished dairy products and by-products.

September 14, 2007

Respectfully submitted,



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