Before the United States Department of Agriculture
Agricultural Marketing Service

In the Matter of Proposed Amendments	:	: Docket Number
to Tentative Marketing Agreements	:	: AO-14-A77, et al.
and Orders	:	: DA-07-02

EXHIBIT
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2/26/07 BPM
COURT REPORTERS
OF AKRON CANTON AND CLEVELAND

Testimony of Dennis J Schad
On Behalf of Land O'Lakes, Inc

February 26, 2007

Exhibit ____

My name is Dennis Schad and I am here to testify on behalf of Land O'Lakes, Inc. My business address is 405 Park Drive, Carlisle PA. I hold a bachelors degree in History from The College of William and Mary in Virginia and a Masters in Business Administration from Virginia Tech. I have worked for Land O'Lakes and its predecessor cooperatives for twenty-five years and my current title is Director of Regulatory Affairs. Prior to this assignment, I have held positions in the cooperatives' milk procurement, marketing and transportation departments. I have testified at numerous Federal and state milk marketing order hearings and before the agriculture committees of several state legislatures.

Land O'Lakes (LOL) is a dairy cooperative with over 3,000 dairy farmer member-owners. The cooperative has a national membership base, whose members are pooled on six different Federal orders. Land O'Lakes owns three cheese manufacturing plants and a butter/powder plant that receive federally regulated milk.

Land O'Lakes supports Proposals 1, 2, 12, 14 and 17, while opposing Proposals 3, 4, 5, 6, 7, 8, 11, 13, 15, 16, 18 and 20. At this hearing Land O'Lakes has no position on Proposals 9 and 10. I will provide evidence for several of the listed proposals and will provide argument through a written brief on others.

Background of Determining Class Prices

Through the informal rulemaking process of Federal Order Reform, the Final Decision of the 2000 Class III and IV Hearing and the most recent Temporary Final Decision (TFD), USDA has developed a process to determine class prices. This process that sets Class III and IV prices replaced the M-W and Basic Formula Price Series. Theoretically Class III and IV prices are now the residual of the market price of a commodity (butter, NFDM, cheese or whey) less the cost of converting milk to that commodity.

Determining the class prices starts with the NASS price series, which describes commodity-specific products, cheddar cheese in 40 pound blocks and 500 pound barrels; butter in 25 kilogram and 68 pound boxes and NFDM and whey in "bag, tote or tanker sales." NASS reports the total price received at plants for the commodities. The manufacturing allowance is fixed; any increases to the selling price to capture increased costs are reported to NASS and all dairy farmers, regardless of whether their marketing organization incurred the costs, benefit from the higher class prices.

The second step of the process is to determine the cost of converting milk to the commodity whose price is quoted in the NASS survey. The Department is scrupulous in making sure that commodity manufacturing costs are tied to the product described by the NASS survey. Additionally, the Department considers the factors that determine the volume of the commodity product that is processed out of a hundred pounds of milk.

The residual of this calculation represents an approximation of the value of milk used in Class III or Class IV products and is used to set Class III or IV prices. The price is designed to be the minimum regulated class price for the commodity. Additionally, USDA has defined the Class IV price to be the market clearing price and has sometimes explicitly added a component for balancing costs in the make allowance calculation.

Land O'Lakes Supports Proposals One and Two

In the Temporary Final Decision (71 FR 67467) the Secretary published product price formulas for Class III and IV milk, based on a weighted average of the Cornell Price Survey and the price survey published by the California Department of Food and Agriculture (CDFA). The spirit of Proposal One is to require AMS to update the product price formulas when an input-survey to the weighted average calculation is updated or changed.

On November 29, 2006 CDFA released its Summary of Weighted Average Manufacturing Costs (Exhibit ___). These results update the CDFA manufacturing plant cost data to 2005 averages. USDA used the updated numbers to calculate the weighted averages contained in Table 4 of the Preliminary Economic Analysis, Class III and Class IV Prices.

Among the recommendations filed in Land O'Lakes' Exceptions and Comments to the Temporary Final Decision (TFD), are two that are especially relevant to Proposal One. First, Land O'Lakes recommends that the CDFA cost of manufacturing whey powder be incorporated into the USDA weighted average calculation that determines Federal order Class III prices. The TFD set the CDFA survey as the "gold standard" of manufacturing cost surveys. The Department chose to abandon the Rural Business Cooperative Service cost survey because the Cornell survey more closely approximated the procedures of the CDFA survey. The CDFA whey powder cost survey includes three plants that aggregately manufacture 98 million pounds of whey. That volume represents 82 percent of the skim whey powder processed in California. The CDFA whey survey is a valid, audited and representative manufacturing cost study that should be included in the Class III price formula calculation.

The second recommendation was to continue the practice of weighting the CDFA and Cornell survey data by sample volume. The TFD weighted the commodity cost by the entire volume of the commodity produced in California or outside of California. For example, the result in the TFD was that the average manufacturing costs of four sampled butter plants in the Cornell survey was weighted by the volume of all of the NASS butter produced by all butter plants located outside of California, rather than the actual volume produced by the four plants. While these four sampled butter plants produced 125.6 million pounds of butter, the impact in the make allowance calculation of the costs of those four plants were weighted as if they had manufactured 995 million pounds. The weighting procedure in the TDF was neither statically valid nor reasonable.

The following Chart summarizes the butter, NFDM, cheese and whey make allowances had USDA used the sample-weighting procedures used by the 2003 Final Decision. Note that CDFA changed its sample in 2005 NFDM survey and utilized costs from nine, instead of ten plants. The impact of that CDFA procedure change is most striking in the medium cost group. For that reason, the following chart used the CDFA NFDM population cost and weight.

Calculation of Weighted Average Cost Using 2002 Methodology

Butter	Volume	Wtd. Cost		Cheese	Volume	Wtd. Cost	
CDFA	396,628	$ 0.1408	55,845	CDFA	826,584	$ 0..1914	158,260
Cornell	125,600	$ 0.1108	13,916	Cornell	963,568	$ 0.1638	157,832
	522,228		69,762		1,792,412		314,454
			$ 0.1336				$ 0.1765
Marketing Allowance			$ 0.0015	Marketing Allowance			$ 0.0015
Butter Make Allowance			**$ 0.1351**	**Cheese Make Allowance**			**$ 0.1780**

NFDM	Volume	Wtd. Cost		Whey	Volume	Wtd. Cost	
CDFA	471,894	$ 0.1659	78,287	CDFA	97,953	$ 0.2851	27,926
Cornell	440,528	$ 0.1423	62,687	Cornell	568,728	$ 0.1941	110,390
	912,422		140,974		666,681		138,317
			$ 0.1545				$ 0.2075
Marketing Allowance			$ 0.0015	Marketing Allowance			$ 0.0015
NFDM Make Allowance			**$ 0.1560**	**Dry Whey Make Allowance**			**$ 0.2090**

Land O'Lakes Table. Sources: Cornell Weighted Average Costs and Volumes are from TFD and CDFA Manufacturing Cost Survey (November 29, 2006).

Summary of Changes

	TFD	PreEcAn[1]	LOL
Cheese	$.1682	$.1711	$.1780
Dry Whey	$.1956	$.1956	$.2090
NFDM	$.1570	$.1662	$.1560
Butter	$.1202	$.1216	$.1351

[1] Preliminary Economic Analysis, USDA, AMS, February, 2007, p 8.

While LOL agrees with much of the spirit of Proposal Two, we offer specific changes to the language of the Proposal. We would like to replace the language that grants the Market Administer the authority to survey plants to an authority granted to the Director of AMS. It is important that the plant survey be national in scope. The sampled plants should be determined by a draw from a national population of plants, located outside of California. Additionally, LOL believes that the results of the national survey should be combined with the CDFA Plant Manufacturing Survey.

LOL also disagrees with section (2) of Proposal Two. We don't believe that commodity make allowances should be snubbed at the cost of the highest cost region. As class prices are determined from commodity product sales from a national market, it is consistent that make allowances be determined by the weighted average of the manufacturing costs of plants across the country. NASS breaks out the sales price of cheese between the Upper Midwest region and the remainder of the nation. Subbing the cheese make allowance at a level that covers the cost of cheese manufacture in that region opens the door to considering the regional price of cheese in determining the region's Class III price Land O'Lakes believes the benefits of a national class price far out weigh a consideration of regional manufacturing prices in the make allowance calculation.

Land O'Lakes believes that the Secretary should conduct a manufacturing cost survey each year based on an adequate number of plants, so that a representative sample of plants is drawn. If the number of plants and the volume produced in those plants is short of the population, then valid statistical extrapolation techniques should be utilized to estimate the population averages. The Secretary should combine the survey of federal order manufacturing plants with the relevant CDFA survey.

Finally, the Secretary, like the CDFA Secretary, should clearly identify a target percentage of volume of product covered by and a target percentage of plants covered by each of the proposed make allowances. For example, the CDFA has stated, "As a general rule, the acceptable level of coverage [by the manufacturing cost (make) allowances] ranges from 50 to 80 percent of the product processed." (CDFA Panel Report, 2/20/05, pg 12) By explicitly considering the volume covered by proposed make allowances, the Secretary will make a more informed decision and offer the industry a clearer sense of the impact of the proposed changes.

Land O'Lakes Opposes Proposal Three

Proponents of Proposal Three request that the Department revise its TFD from the January 20, 2006 hearing from a weighted average of Cornell and CDFA manufacturing costs to one that includes only Cornell weighted averages. Since the 2000 Federal Order Reform Decision, the Department has, as a matter of policy, combined relevant manufacturing cost from California and plants outside of California. In the Final Decision from the 2ooo Hearing, the Secretary wrote:

> The use of manufacturing plant data from California plants that do not procure any of the milk that would be priced using those costs should not cause concern. The costs of manufacturing dairy products may vary slightly by region, but adoption of representative make allowances in product price formulas should not fail to use a well documented study that includes a large amount of audited data, such as the CDFA survey. (67 FR 67915-6)

As long as the Department determines product prices from a national NASS survey that includes California commodity prices, it is appropriate for AMS to include California manufacturing costs in the make allowance determination.