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January 28, 2003

VIA FEDERAL EXPRESS

Mr. Richard M. McKee
Deputy Administrator, Dairy Programs
USDA-AMS-Dairy Programs
1400 Independence Avenue, SW
South Building - Room 2968
Stop 0225
Washington, D.C. 20250-0225

Re: Proposal to classify evaporated milk as a Class IV product

Dear Mr. McKee:

This proposal is submitted on behalf of O-AT-KA Milk Products Cooperative, Inc. ("O-AT-KA"). O-AT-KA is owned by the farmers belonging to Upstate Farms Cooperatives, Inc., Niagara Milk Cooperative, Inc. and Dairylea Cooperative Inc. Total membership of these cooperatives is over 2000 producers located in several northeastern states.

O-AT-KA is hereby requesting that the USDA schedule a hearing on an emergency basis for this proposal to classify evaporated milk in consumer-type packages (referred to as Evap) as a Class IV product. The problems resulting from Evap's current mis-classification as a Class III product will become ever more acute in the very near future because of changes in market conditions and USDA policies relative to class price formulas and support program purchase prices. The livelihoods of farmers owning and supplying O-AT-KA, and those farmers supplying other Evap processors, will be placed in jeopardy if this issue is not addressed administratively on an emergency basis.

The market for Evap products represents approximately 900 million pounds of milk according to the American Dairy Products Institute survey (see Attachment 1).[1] This survey also shows that the regular Evap market has been declining and is down by over 40% since 1979. The largest manufacturer, Nestle, produces its product in California. Nestle closed its other Evap plant located in New York in the early 1990s. The higher milk cost in New York was likely a contributing factor in this plant closure. Other manufacturers, in addition to O-AT-KA, are Diehl, Inc., which is based in Ohio with plants also in Michigan and Idaho, and Milnot Holding Corporation located in Missouri.

Historical Basis of Classification

USDA has placed Evap products in the lowest use classification for decades. In the uniform classification decisions of 1974 that reviewed Class I, II and III classification, USDA stated:

"A Class II classification should not apply to evaporated or condensed milk or skim milk in consumer-type containers as the cooperatives proposed. Such storable products should remain in the lowest price class. A Class III classification for producer milk in these products will permit such uses to remain as a competitive outlet for milk surplus to the needs of the Class I market. Such products made from milk regulated under these orders must compete over wide areas with same products processed from ungraded milk or milk that is often priced at no more than the Minnesota-Wisconsin price. Comparable pricing should prevail under these 32 orders." 49 Fed. Reg. at 8491-8492 (1974).

When national uniform classification was considered in 1993, and specifically Class II and Class III products were reviewed, Evap was again left unchanged in its Class III designation. About that time, USDA created a separate and narrow use classification (IIIA) for nonfat dry milk only. Pricing of Class III for much of this time was based on a competitive pay price survey known as the M-W price series. In 1998 and 1999, when the Federal Order reform process was taking place, Evap yet again was left in its historical classification as a Class III milk product. However, the lowest use or manufacturing classes were more definitively split between Class III and Class IV. Class III became a cheese use class based on a cheese yield and cheese pricing formula. A few other products such as anhydrous milkfat that are mostly butterfat were left in Class III, as the Department has considered it unnecessary to reclassify when there is the same

[1] This milk equivalent is based on the 40 pounds product weight referenced by ADPI and, for simplicity, based on the 23% solids minimum in evaporated milk, multiplying by 2 to equal 80 pounds of raw milk per case and multiplied by the number of cases of evaporated and related products reported.

milkfat price for Class III and Class IV. Reclassification of Evap with a high nonfat solids content to a more appropriate Class IV classification, however, was overlooked.

It is also important to understand, in contrast, the historical context for the nation's leading Evap manufacturer that is located in and operating under the California Marketing and Stabilization Plans (California State Order). Historically in California, the lowest and residual classification of milk was Class 4 and since the early 1960s was based on butter and nonfat dry milk pricing formulae. Until the late 1980s this classification contained not only butter and nonfat dry milk but also cheese and a number of other storable products including Evap. When California created a separate cheese use classification, known as Class 4b, Evap remained in the residual classification which became Class 4a. Therefore it continues to be based on butter and nonfat dry milk pricing formulas.

Thus, while California classifies and prices Evap on a solids basis, the federal orders price it off the cheese market. Current and expected future problems in pricing Evap on a Class III cheese use basis will be increasingly damaging to the Federal Order marketers and are a compelling reason for reclassification. Moreover, the expected increased disparity of treatment between Federal Order manufacturers and the market leader in California, as will be discussed, makes it all the more urgent for USDA to call a hearing promptly.

Evaporated Milk Belongs in Class IV

Regular evaporated milk products are made by evaporation of water from raw milk resulting in a milk solids content of a minimum of 6.5% butterfat and 23% total solids. Skim Evap and filled Evap are other Evap products with different standards of identity based on solids and fat. The content or yield of Evap from raw milk is driven by the nonfat solids content of the incoming milk in a fashion similar to nonfat dry milk. The higher the nonfat solids in the incoming milk, the less water needs to be evaporated and the more cans of product result from the raw milk. Production of Evap is in no way related to protein-driven curd development so critical to cheese production and therefore has little relationship to the cheese yield-based Class III pricing formula.

Evap is retorted in steel cans so that it is sterile and has an un-refrigerated shelf life that can exceed 12 months. Shelf life of a year or more with no need for refrigeration is a characteristic that historically caused USDA to identify Evap in the lowest use class. Because of this shelf life, manufacturers have the flexibility to produce and inventory products for use in other time periods. Therefore it made sense decades ago when USDA determined that Evap should be in the lowest use classification of storable manufactured

products, and nothing has changed in the meantime that would suggest putting Evap in other than the lowest classification.

However, there are now two manufacturing or storable product classes: Class III and Class IV. Federal Order reform in 2000 made it plain that Class III pricing is tailored exclusively for *cheese* products. The decision hinged Class III prices on the price of cheese, make allowances for cheese, and yields for cheese. Evap in no way competes with cheese in product use. Because evaporated milk is similar to powdered milk in that it has a long shelf life, does not need refrigeration and is based on nonfat solids rather than protein, (all characteristics more similar to nonfat dry milk than to cheese), it only makes sense that Evap, from a policy perspective, be placed in the same class as powdered milks.

The properties of storability and nonfat solids-based yields that Evap shares in common with powdered milk mean that Class IV is now the appropriate classification. The problems resulting from the current mis-classification make it critical that Evap be placed in the Class IV category as soon as possible.

Increased Pricing Disparity Threatens Canned Evaporated Milk Manufacturers Operating Under Federal Orders

The issues associated with classifying Evap as a Class III product instead of as a Class IV product are changing from policy considerations to harsh competitive realities because of changed regulations and market conditions.

First, the recent USDA decision (in the Class III/Class IV hearing) will increase the Federal Order Class III price of milk used in Evap products – particularly the protein costs. The difference in protein content creates a raw product cost difference between federal and non-federal manufacturers that cannot be recovered in the marketplace or on yields of product. These changes make it obvious that evaporated milk should no longer be priced as Class III. This decision also increases the average spread between Class III and Class IV (and California 4a) prices, making it even more disadvantageous to use Federal Order Class III milk for Evap products.

Second, the other major policy change that creates harsh competitive realities out of these policy concerns is the butter-powder tilt that was announced in November, 2002. This decision reduced the nonfat dry milk support price to $0.80/lb. Market prices of nonfat dry milk are dropping and forecasters believe that prices will ultimately fall near to the support price. Once again, as with the Class III/Class IV decision, the average spread between Class III and Class IV (and California 4a) prices will increase. Dr. Mark Stephenson, a leading dairy economist from Cornell University, has estimated that the

spread may grow to as much as $2.75 per hundredweight this fall (see Attachment 2). Thus, according to this forecast, cheese prices are expected to increase as milk supplies tighten, but nonfat dry milk prices are expected to remain flat due to continued production particularly in California and the West Coast. Other forecasters have suggested the possibility of an even wider spread. The current futures markets also indicate a widening disparity this fall.

Adding urgency to this flawed classification for Evap is the presence in California of the nation's largest Evap manufacturer that pays for milk based on the Class 4a price, which is similar to and often lower than the Federal Order Class IV price. All told the difference in raw milk prices could well soon be over $2.00/cwt. Bids for Evap business are so competitive that they are won and lost on the basis of a few cents per case. We believe a significant difference in price could exist for extended periods of time, giving the California plant a permanent competitive advantage. The competitive advantage enjoyed by this California manufacturer threatens the business of O-AT-KA. The vulnerable position faced by O-AT-KA is also faced by Milnot and Diehl, Inc.

The combined effects of USDA policy changes and market conditions threaten to force the Federal Order evaporated milk plants out of production, losing this market for the milk of Federal Order producers and causing the milk to be turned into powder that pays Class IV pricing. Given the overall declining trend in Evap sales, clearly this is a product that cannot carry an additional burden of class prices higher than Class IV.

No Significant Impact on Blend Prices

Lowering the classification of Evap from Class III to Class IV will not have a significant impact on blend prices in the Federal Order system. Based on our estimate that Nestle's market share (from its California plant) is about 50% and given a total pooled federal order supply of 120 billion pounds in 2001, we estimate that milk used to produce Evap under Federal Orders is less than ½ of one percent of the Federally regulated milk supply. Therefore, assuming an average price spread of $1.20 between Class III and Class IV, the average reduction in the blend price will be less than $0.005 per cwt. Enabling Federal Order producers to compete for this Evap market by reclassifying Evap to Class IV would not hurt other dairy farmers by materially reducing their blend price, but failing to do so would seriously impact those dairy farmers who have invested in and/or otherwise supply milk for the Evap market.

In any event, this analysis overstates any resulting reduction in the blend price because, due to the competitive factors described above, we expect that most, if not all, of the Evap plants in the Federal Order system will stop production in the foreseeable future unless the price of their milk is placed on a more competitive Class IV basis. If

that occurs, milk that had been used for Evap and priced at the Class III price would end up as powder priced at the Class IV price (the same Class IV price as if this proposal is adopted).

In summary, we ask that USDA preserve the historical classification of Evap milk in the lowest manufacturing use class. It is clear that Evap should be a Class IV product and not continue to be misclassified as a Class III cheese use. Furthermore, given the impending price disparity discussed, the only way O-AT-KA and its dairy farmer owners will receive relief is for USDA to call a hearing on an emergency basis and act as soon as possible in accordance with its authority under the APA (5 U.S.C.§ 557 (b)(2)), the AMAA, and departmental regulations. 7 C.F.R. § 900.12.

The proposed change in the language of the nationwide classification provisions for Federal Orders is in Attachment 3.

The existing language of 7 C.F.R. §1000.40 (c)(1)(iii) includes sweetened condensed milk as well as evaporated milk in consumer-type packages. O-AT-KA does not currently produce sweetened condensed products and therefore has not specifically addressed that product in this petition. However O-AT-KA would not object to also placing sweetened condensed milk in consumer packages in Class IV.

We would appreciate the opportunity to meet with you and your staff to review these proposals, provide any additional information that may be appropriate, and answer any questions which you may have.

Thank you in advance for your consideration of this proposal and request for emergency handling.

Very truly yours,

Marvin Beshore

MH:ch

cc: Mac McCampbell: Chief Operating Officer, O-AT-KA Milk Products Cooperative, Inc.
Bob L. Hall: Chief Executive Officer, O-AT-KA & Upstate Farms Cooperative, Inc.
James Miklinski: General Manager, Niagara Milk Cooperative, Inc.
Rick Smith: Chief Executive Officer, Dairylea Cooperative Inc.

ATTACHMENT 1

American Dairy Products Institute

300 West Washington Street, Suite 400 - Chicago, Illinois 60606-1704 U.S.A.

(312) 782-4888 or -5435 FAX (312) 782-5299

Email: adpi@flash.net Web site: http://americandairyproducts.com

REVISED

EVAPORATED MILK PRODUCTION

Figures reported in cases (48 tall equivalent)
based upon manufacturers' reported production to ADPI

	Production	
Year	Evaporated Milk	Evaporated Milk & Related Products[1]
1979	17,110,000	-
1980	15,500,000	-
1981	15,840,000	-
1982	15,050,000	-
1983	14,300,000	16,612,000
1984	13,700,000	15,892,000
1985[2]	14,360,000	16,537,000
1986	12,996,000	14,881,000
1987	12,966,000	14,759,000
1988	13,357,000	15,164,000
1989	12,451,000	14,193,000
1990	13,169,000	14,895,000
1991	11,313,000	12,776,000
1992	12,153,000	13,595,000
1993	11,561,000	13,114,000
1994	10,585,000	11,771,000
1995	10,847,000	12,462,000
1996	9,853,294	11,271,002
1997	10,656,280	12,204,278
1998	10,274,995	11,843,149
1999	10,380,167	11,932,786
2000	9,666,286	11,004,069
2001[3]	9,956,421	11,166,714

[1]Includes Evaporated Milk plus Evaporated Skimmed Milk, Evaporated Lowfat Milk, & Evaporated Filled Milk.

[2]Product weight/case since 1985: 40 lbs.

[3]Revised.

ATTACHMENT 2

CORNELL
UNIVERSITY

Program on Dairy Markets & Policy
Department of Agricultural, Resource and Managerial Economics

New York State College of
Agriculture and Life Sciences

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Tuesday, December 17, 2002

Craig Alexander
P.O. Box 718
Cedar & Ellicott Streets
Batavia, NY 14021-0718

Dear Craig,

As per your request, please find below a copy of my price forecasts for the coming year. As you will note, I am optimistic that class III prices will rebound sharply in the second half of the year. I believe that reduced cow numbers and milk per cow that is below trend growth will tighten milk supplies by then. Dairy product buyers will become aware of tightening milk supplies about the time that they are considering purchases for the fall demand season. I am expecting that they will bid cheese prices sharply higher.

I am not so optimistic with my class IV price forecasts. The change in tilt was necessary (in my opinion) but it will lower class IV prices. Butter will still be moved mostly by the markets but CCC purchases may help to draw down excessive stocks. NDM should drop to support rather quickly leaving class IV at a considerably lower level than class III in the second half of the year. If milk solids are a much better buy in the form of powder than they are in wet solids, there will be some arbitrage between classes. However, I don't think that it will be enough to close the gap.

Sincerely,

Mark Stephenson, Ph.D.
Cornell Program on Dairy Markets & Policy

Date	Class III	Class IV	Uniform*	CI Mover
Jan-03	$10.30	$10.50	$12.52	$10.62
Feb-03	$10.60	$10.65	$12.67	$10.52
Mar-03	$11.00	$10.75	$12.90	$10.66
Apr-03	$11.25	$11.00	$13.11	$11.00
May-03	$11.25	$11.00	$13.17	$11.24
Jun-03	$11.50	$11.00	$13.27	$11.24
Jul-03	$13.00	$11.15	$13.91	$11.47
Aug-03	$13.50	$11.15	$14.14	$12.90
Sep-03	$13.50	$10.75	$13.99	$13.38
Oct-03	$13.00	$10.55	$13.63	$13.38
Nov-03	$12.80	$10.55	$13.50	$12.90
Dec-03	$12.25	$10.50	$13.27	$12.71
Average	$12.00	$10.80	$13.34	$11.83

ATTACHMENT 3

Proposed changes in 7 C.F.R. Section 1000.40, applicable to all orders:

1. Delete from Section 1000.40(c)(1)(iii) the words "Evaporated or" and

2. In Section 1000.40(d)(1), delete "and" from subsection 1000.40(d)(1)(i) and add a subsection (d)(1)(ii) as follows: "(ii) Evaporated milk in a consumer-type package; and"