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UNITED STATES DEPARTMENT OF AGRICULTURE
BEFORE THE SECRETARY OF AGRICULTURE

In re:	)	
Milk in the Northeast and	)	
Other Marketing Areas;	)	Docket Nos. AO 14-A69, *et al.;* DA-00-03
Hearing on Class III and	)	
Class IV Milk Pricing	)	
Formulas	)	
	)	

BRIEF AND COMMENTS AND PROPOSED FINDINGS OF FACT AND CONCLUSIONS OF LAW FILED ON BEHALF OF MASTER DAIRIES, INC.

Respectfully submitted,

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July 14, 2000

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INTRODUCTION

For over 65 years, the United States Department of Agriculture has strived mightily to properly set the minimum prices for milk used to produce the different classes of dairy products. In particular for over 30 years, USDA and the dairy industry have attempted to address the proper value for both skim milk and butterfat in the various classes of milk, especially the Basic Formula Price. Beginning at least with the establishment of a national basic formula price and butterfat differential in the early 1970's, USDA has held a significant number of hearings (2 butterfat differential hearings in the 80's, the 1990 National Hearing, the 1992 M-W Replacement Hearing, the Federal Order Reform process and now the 2000 Emergency Hearing on Make Allowances) dedicated in part to consideration of these issues. Unfortunately, despite, or perhaps because of, industry assistance, USDA is criticized after each decision is made for not having gotten the basic formula price or butterfat issues "quite right."

The Basic Formula Price is now effectively a ratemaking provision which requires USDA to engage in full and complete analysis of all rate factors including a rate of return. Moreover, there is something far worse than not getting the value of butterfat exactly right, and that is getting the relative values of butterfat in different classes of milk precisely wrong. In attempting to address the multi-headed hydra that is represented by both the make allowance calculations and the butterfat value in milk, it is critically important that USDA in dealing with this Herculean task not create new problems in trying to solve perceived or existing problems. Master Dairies, which is owned by ten processing companies operating 30 dairy processing plants nationwide, files this Brief and Comments and Proposed Findings of Fact and Conclusions of Law for the purposes of addressing the make allowance and butterfat issues. Master Dairies also opposes proposal number 1, the adoption of which would cause the Chicago Mercantile Exchange ("CME") product prices to be used for price setting purposes in lieu of the National Agricultural Statistical Survey ("NASS") product prices.

Master Dairies opposes make allowance and product price formula proposals which would unjustifiably increase the cost of Class I milk while decreasing the cost of Class IV.

Master Dairies also believes that USDA should address the question of whether use of the unadjusted Grade AA butter price in establishing butterfat values is consistent with past USDA practices and with the concept of minimum pricing. Master Dairies testified at the hearing that the failure to account for the previously used Grade A butter price has led to overvaluation of cream by the federal order system, precisely because the principles of minimum pricing and past regulatory practices have been overlooked. Furthermore, and more importantly, if the butterfat issue is to be addressed in this proceeding, then the value must be the same on Classes II, III and IV in order to avoid creating new disorderly marketing conditions in the regulatory process. Master Dairies therefore urges adoption of proposal number 3 and rejection of proposal number 8.

FINDINGS OF FACT AND CONCLUSIONS OF LAW

Master Dairies proposes the following findings of fact and requests that the Secretary make a ruling on each proposed finding under the provisions of the Administrative Procedure Act, 5 U.S.C. § 557(c).

A. Master Dairies

1. "Master Dairies is a purchasing association owned by ten dairy processing companies who operate 30 dairy plants, mostly fluid milk processing operations, in 12 states covered by Federal Milk Orders and with distribution in about 30 states." Tr. 821, lines 12-16. Master Dairies estimates that its "U.S. member companies' dairy product sales represent the bulk of [its] member companies' business, a number of [its] members also produce a variety of Class II products, including ice cream, cottage cheese, yogurt and sour cream." Tr. 821, lines 17-22.

B. Make Allowance Issue

2. Master Dairies concurs with the position taken by IDFA with respect to the make allowance issues raised at the Hearing. Therefore, Master Dairies opposes changes to the Class III and Class IV formulas for the reasons stated in its hearing testimony. This Brief amplifies two critical issues before USDA with respect to the make allowance issues: (1) that supply and demand factors do not support any change to the price formulas; and (2) that having undertaken ratemaking in the form of final product pricing and costing, USDA is required by law to consider all relevant factors, including a rate of return, in setting minimum prices.

3. First, Master Dairies opposes proposals to decrease the Class III make allowance or to alter other factors in the Class III and IV formulas which would increase the Class I price while decreasing the cost of Class IV milk. These proposals fail to reflect supply and demand market conditions for fluid milk use and should be denied. Tr. 822, lines 1-6.

4. As to the alleged need to change or lower the make allowances, "these changes will likely have an elevating impact on Class I prices. However, we need to remember that USDA made a finding in the Final Rule that a sufficient quantity of fluid milk would be available under final rule prices." Tr. 823, lines 17-21.

5. "Congress chose to further increase the Class I differentials in many markets, leading to an overall increase in the all milk price. While there were some relatively modest changes to USDA's modified [Option] 1A, the Regulatory Impact Analysis, Appendix Table 17, page 66 [Ex. 24], provides the best evidence of the price enhancing impact, approximately a nine cent increase in the all milk price over that which was thought by USDA to generate a sufficient quantity of milk for fluid use, which was the modified Option 1B." Tr. 823, line 24 through Tr. 824, line 6.

6. Having determined that pre-Option 1A (9 cents less) federal order reform provided for a sufficient price to bring forth the needed milk, USDA cannot possibly turn around today and say that prices need to be further enhanced beyond the 9 cents granted by Congress.

7. "Hearing proposals which would further increase the all milk price, therefore, are not justified. Indeed, none of the Master Dairies U.S. member companies are having difficulty procuring a raw milk supply for fluid use precisely because there is more than a sufficient supply of milk for fluid use nationwide. While there may be isolated and limited time wise and geographically limited needs to import milk into the southeast, it is impossible for anyone to argue that there is not a sufficient supply of milk in the United States today." Tr. 824, lines 7-16.

8. "U.S. milk production is up 5.1 percent for the period January through March, 2000, over the same period a year ago. In addition, the number of milk cows and production are higher than for the years 1998 and 1999, 58,000 in March, 2000 over March 1998, reversing a long-term trend in the other direction." Tr. 824, lines 17-22.

9. "Many of the proposals in this hearing would increase milk prices despite these increases in production and cow numbers. The result of such higher prices logically will be decreased consumption of fluid milk by dairy farmers. The cumulative effect will be to depress manufacturing milk values, further complicating the dairy industry's need to transition to a more market oriented approach." Tr. 824, line 23 through Tr. 825, line 5.

10. Therefore, there is no record evidence justifying any increase in Class I prices by enhancing any price mover.

11. Second, USDA, having undertaken a final product price and cost valuation for Class III and IV milk, must insure that it captures the full cost of making products in order to match those costs against the full market price. If it does otherwise, USDA will provide only a incomplete picture of the total costs and would overvalue the milk in the various market clearing categories, contrary to its stated procedure for 30 years. See e.g., 36 Fed. Reg. 17850 at 17581 (September 2, 1971).

12. While nothing in the AMAA required USDA to undertake this kind of ratemaking, once undertaken, USDA must abide by rules governing ratemaking of this sort. Those rules require USDA to be as complete as possible in considering every possible aspect of the rate which is being set; furthermore, USDA must publicly disclose its consideration and rationale for adopting or excluding each and every rate factor. See, American Telephone and Telepgraph Co. v. Federal Communications Comm'n, 974 F.2d 1351 (D.C. Cir. 1992) (vacating

an FCC order as arbitrary and capricious because the Commission failed to provide an adequate explanation for its refusal to consider a particular rate factor in changing its policy).

13. In ratemaking cases in other regulatory arenas it has become the accepted and required practice that a rate of return must be considered when calculating regulated price levels. In re Permian Basin Area Rate Cases, 390 U.S. 627 (1967) rehearing denied, 392 U.S. 917 (1968). The test for what is or is not a proper rate of return has been explicitly stated by the Supreme Court as early as 1923. In Bluefield Water Works and Improvement Co. v. Public Service Comm'n, 262 U.S. 679 (1923) the Supreme Court stated that what "rate [of return] will constitute just compensation depends upon many circumstances and must be determined by the exercise of a fair and enlightened judgment, having regard for all relevant facts." Id. at 692-693. This standard was further articulated in Federal Power Comm'n v. Hope Natural Gas Co., 320 U.S. 591 (1944). In that case the Supreme Court stated that the revenue obtained from a rate should allow not only operating expenses but also capital costs and noted that:

> By that standard the return to the equity owner should be commensurate with return on investments in other enterprises having corresponding risks. That return, moreover, should be sufficient to assure confidence in the financial integrity of the enterprise, so as to maintain its credit and to attract capital.

Id. at 603.[1]

14. At least one of the cost surveys or analyses presented at the hearing was originally created for a purpose other than federal milk order product pricing and cannot readily be adapted for the purpose now intended because it fails to meet the standards articulated above. Tr. 73 line 12 through Tr. 80, line 16. This is not a criticism of the underlying study or those who perform it, it is simply a statement that the Rural Business Cooperative Service performs the task for

[1] This ratemaking discussion does not apply to minimum payments to farmers because those payments are specifically governed by the minimum payment provisions and supply and demand factors of 7 U.S.C. § 608c(18).

which it was designed 16 years ago very well. Only that task 16 years ago did not include make allowances for ratemaking purposes. Many of the other purported analyses, performed by the parties, similarly fail to account for many of the rates which ought to be considered, using the ratemaking analysis contained in this Brief. For instance profit if obviously not factored into one other expert's proposal. Tr. 548, line 23 through Tr. 549, line 2. Yet USDA has correctly concluded that profit must be a factor in setting market-clearing prices:

> The importance of using minimum prices that are market-clearing for milk used to make cheese and butter/nonfat dry milk cannot be overstated. The prices for milk used in these products must reflect supply and demand, and must not exceed a level that would require handlers to pay more for milk than needed to clear the market and **make a profit**.

64 Fed Reg. 16026 et seq. at 16094, c.3 through 16095, c.1 (April 2, 1999) (emphasis supplied).

15. As USDA undertakes the analysis for calculating Make Allowances, Master Dairies notes that it is not acceptable to average or weight one valid study with a study which does not meet all of the standards articulated herein. For instance, USDA, in order to use the RBCS study at all, must first adjust the numbers in that study for all relevant rate factors articulated by cheese manufacturers in the hearing or explain sufficiently under the standard enunciated in American Telephone and Telegraph, supra, why any one or more factors are not included. Other studies must be similarly scrutinized. Failure to do so would invalidate any conclusions reached concerning the make allowance portion of this proceeding.

16. Master Dairies maintains that when USDA performs this analysis, resulting make allowances are likely to be at or above present levels. Therefore, it is not likely that any party or USDA can legally and economically justify reducing make allowance levels especially for Class III price formula purposes.

C. Butterfat Pricing

(1) Issues Presented and the Concept of Minimum Pricing

17. Prior to the implementation of federal milk order reform on January 1, 2000, and for over 25 years, USDA had used the Grade A butter price as announced by the CME, or the Grade AA butter price adjusted downward by nine cents to reflect Grade A butter values, for the butterfat differential in the basic formula price. This value was then used to calculate each of the prices for all four classes of milk Class I, Class II, Class III and Class III-A. After January 1, 2000, USDA has used the unadjusted NASS Grade AA price for butter. Mathematically this differs from the prior regulatory procedure in two ways: (1) the Grade AA price is higher than the Grade A price for butter; and (2) the NASS price averages below the CME price. Tr. 799, lines 3-11.

18. USDA previously determined in 1998 that the Grade A price was no longer reported sufficiently for price announcement purposes and that a proxy for the Grade A price was necessary in order to maintain the continuation of the various federal orders. This proxy was the Grade AA price adjusted to Grade A price levels. In adopting the Grade AA price adjusted to Grade A price levels, USDA determined that the difference between the CME Grade AA and Grade A butter prices should be 9 cents per cwt. 63 Fed. Reg. 35564 (June 30, 1998). Meanwhile, the NASS and CME Grade AA prices are not precisely the same. While the actual difference between the NASS and the CME has averaged approximately 1.6 cents per cwt (Tr. 1334, lines 22-25), the industry has a whole has been assuming a 3 cent difference for purposes of this proceeding. In order to approximate the old CME Grade A price, it is necessary to make two adjustments to the NASS Grade AA price for butter. First, subtract 9 cents for the difference between Grade AA and Grade A, and second, add back the 1.6 or 3 cent difference between

NASS and CME Grade AA. Therefore, while a 7 or 7.5 cent adjustment to the NASS Grade AA price could be justified, Master Dairies concurs with the industry consensus that a 6 cent downward adjustment would be acceptable. Tr. 822, lines 19-22.

19. As of January 1, 2000, USDA has adopted unadjusted NASS Grade AA pricing for butter. A significant number of witnesses at the hearing asserted that they were negatively impacted economically by this decision. Notwithstanding the disagreements about everything else in the hearing record, including the methods that should be used to fix any problem, virtually every witness agreed that USDA's decision to use an unadjusted Grade AA butter price as applied to all classes of milk was ill advised and required some form of modification in order to return to the pre-federal order reform status quo. It is important to recognize that proponents of proposal 3 (which would, for Class II, III, and IV milk, subtract 6 cents per pound from the NASS Grade AA butter price before adjusting for the make allowance and yield factor) are attempting a return to the previous status quo and are not seeking a real change in regulation. The real change in regulation was USDA's departure from the use of the Grade A price directly or through a proxy. Proposal 8 (which would, for Class IV milk only, subtract 6 cents from the final calculation of the butter price formula) is also a departure from the previous status quo as its justification allegedly is not Grade A based. Tr. 1341, lines 12-14.

20. Both proposal number 8 and USDA's decision embodied in the Final Rule are subject to increased scrutiny and to an increased burden of proof because they would each change previous regulations. In Motor Veh. Mnfrs. Ass'n v. State Farm Mut. Ins. Co., 463 U.S. 29 (1983), the United States Supreme Court struck down newly enacted automobile air bag regulations on the grounds that the shift in regulation was not justified based upon past agency decisions. The new regulation because it represented a change in course required greater

justification than would be required when creating new regulations on a clean slate. So, too, must USDA and proponents of proposal 8 be subject to increased scrutiny in eliminating the use of the Grade A butter price. Master Dairies submits that neither USDA nor proponents of proposal number 8 can overcome this heftier burden. As discussed in this Brief, the return to a proxy for the status quo is fully justified and mandated by the Supreme Court's holding in Motor Veh. Mnfrs. Ass'n.

21. Proponents of proposals which would address the butterfat issue maintain that for one or more classes of milk, an adjusted Grade AA price should be used instead. While some proponents who would limit the return, if any, to an adjusted Grade AA price to Class IV only couch their proposal in terms of balancing or other increased handling costs, Tr. 1200, line 24 through Tr. 1202, line 11, the reality is that those persons want effectively the same adjustment to the Grade AA price as those who express a desire to return to a proxy for Grade A butter pricing. Tr. 1341, lines 12-14. Moreover, Class II and III handlers incur the same costs as those allegedly uniquely incurred by Class IV handlers. See, e.g. Tr. 799, line 25 through Tr. 800, line 6.

22. The industry, with the support of USDA, has long recognized the core concept that market clearing minimum prices should be based on manufacturing values. Tr. 798, lines 13-15. For instance, in 1971, in an federal order proceeding dealing with the butterfat differential for the northeastern orders, USDA announced: "The [butterfat] differential as proposed would place less value on the butterfat portion of milk and more value on the skim and thus would better relate the costs of butterfat and skim milk to market values of their respective products." 36 Fed. Reg. 17580 et seq. at 17581 (September 2, 1971)(official notice requested).

23. Unfortunately, as a result of industry oversight in the federal order reform process, including legislation and litigation (a case of the industry missing individual trees when spending too much time fighting over the forest), "the present system establishes minimum prices for butterfat that may not be at market clearing levels because bulk fluid cream is sold into an unregulated market." Tr. 1333, lines 21-24. While the industry may have missed the issue, perhaps everyone in the industry and USDA missed the implications of what occurred until after federal order reform was implemented and sellers of surplus cream began to suffer losses in the marketplace. Tr. 1360, lines 21-25.

24. "Presently Class I processors purchasing raw milk for fluid needs must account to the pool on the butterfat portion of their milk at a butterfat value that is based off of a Grade AA butter price instead of a Grade A butter price or its equivalent." Tr. 1333, line 25 to Tr. 1334, line 4.

25. "Periodically during the year there are supply and demand situations when Class II, III or IV processors that purchase bulk cream are simply unwilling to pay more than the manufacturing value for that cream. Thus, the Class I processors pool obligation on the butterfat portion of raw milk during this period can exceed the revenue that can be extracted from the marketplace." Tr. 1334, lines 5-11. This is precisely why the use of a Grade A price proxy is valuable. That Grade A price is meant to maintain the operation of the federal orders at minimum prices established after 25 years of federal order hearings. 63 Fed. Reg. 35564 (June 30, 1998).

26. Indeed the problem with the present butterfat price formulation is that it simply fails to account for the doctrine of minimum pricing. According to the witness for the one proprietary company producing butter, only 95% of its production is Grade AA. This means that 5% is either Grade A or B; however, those who account to the pool for that volume of cream are

required to account as if 100% is Grade AA. This necessarily overvalues the cream and is contrary to USDA's stated purpose – "to better relate the cost of the butterfat . . . to market values." 36 Fed. Reg. at 17581. In addition, there was testimony that several Class II products are priced in the marketplace based upon the Grade A price. Tr. 1332, lines 21-24 and Tr. 1347, lines 12-13. The fact that any Class II product relies upon the Grade A price as opposed to the Grade AA price does matter because the purpose of minimum pricing is to effectively find the "lowest common denominator" for products in that class of milk. Products simply should not be forced to be sold at a loss as noted by USDA in 1971, again with respect to the Class III-A debate in the early 1990's. 57 F.R. 49633 *et seq.* (November 3, 1992)), and in the Final Rule issued as a result of federal milk order reform:

> The importance of using minimum prices that are market-clearing for milk used to make cheese and butter/nonfat dry milk cannot be overstated. The prices for milk used in these products must reflect supply and demand, and must not exceed a level that would require handlers to pay more for milk than needed to clear the market and make a profit.

64 Fed Reg. 16026 <u>supra</u>.

27. Moreover, Grade A butter production is not obsolete. In addition to the witness for the proprietary butter operation, Mary Keough Ledman, the qualified expert witness, testified that she has estimates that Grade B and Grade A butter production range from 3 to 7% of total butter production. "U.S. butter production in 1999 totaled approximately 1.2 billion pounds of butter. Roughly speaking then, approximately five percent of that or 55 million pounds could be Grade A or Grade B keeping in mind that Grade A and Grade B butter is made from whey cream. The industry long accepted the Minnesota/Wisconsin milk price based upon Grade B

milk produced in Minnesota and Wisconsin that did not reflect any more than two to three percent of total U.S. milk production." Tr. 1338, lines 16-25.[2]

28. Grade A and B butter will continue to be produced in the future and will not be treated as Grade AA. Tr. 1338, lines 10-21. This means that Grade A and Grade B butter will continue to produced indefinitely. USDA need not be concerned that there will not be an available market for Grade A or Grade B butter.

29. When the M-W was finally replaced, the replacement was intended to reflect that same price, without being price enhancing. "The hearing record indicates that current price levels are achieving a reasonable balance between supply and demand for milk. Present price levels are ensuring consumers of an adequate supply of milk while maintaining sufficient reserve supplies." 60 Fed. Reg. 7290 et seq. at 7297 (February 7, 1995). Leaving aside the question of whether USDA succeeded with the M-W and BFP replacements in not providing price enhancement, the point remains that USDA recognized that the replacement for the M-W and BFP should not be price enhancing precisely because it was attempting to provide a market clearing minimum price.

30. That is precisely what proponents of proposal number 3 are seeking, a replacement for the old Grade A butter price that is not price enhancing. There was and is no reason to cease using a "minimum" price. Unfortunately, USDA's adoption through the federal order reform process has created a solution that ignores both minimum pricing and the tortured 30 year history of butterfat pricing.

31. Those parties who contend that the butterfat provisions should not be changed because any change will result in less money to producers ignore several facts and legal issues.

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[2] In fact, the NASS Dairy Products 1999 Summary issued in April 2000 (official notice requested page 66) indicates that butter from whey cream was 18.85% of total butter, meaning that Grade A and Grade B butter production is

First, the adoption of Option 1A as a result of Congressional action and the adoption of the Class I price mover as the higher of Class III and Class IV were both significantly price enhancing for dairy farmers. The Option 1A Class I differential price enhancement came in the face of USDA's conclusions that Option 1B brought forth an adequate supply of pure and wholesome milk. Ex. 24.

32. The use of the higher of the Class III and Class IV price enhancement came in the face of public excoriation by some dairy farmer groups claiming, falsely as it turns out, that Class IV prices would not be appreciably above Class III prices for any significant period of time. Therefore, there is every reason to believe that notwithstanding low milk prices paid to producers, that minimum prices are higher than they would otherwise have been absent federal order reform and absent Option 1A.

33. Second, to the extent that the industry missed the implications of the butterfat issue in the final rule, the resulting price was unexpectedly price enhancing for producers. Assuming that a change is made, eliminating unexpected and unlooked-for price enhancement hardly counts as price reduction.

34. Finally, opponents of re-examining the butterfat price are wrong because the amount of money paid to producers, whether too much or too little, is not the entire focus of the federal order system. From a legal standpoint, there is no statutory basis for their position that the Secretary's primary, if not sole, function under the Agricultural Marketing Agreements Act ("AMAA") is to protect producers' incomes. These groups' premise that congressional policy, as embodied in the AMAA, the Federal Agriculture Improvement and Reform Act of 1990 ("FAIR"), and Congressional budget action taken in 1999, is to maintain – indeed, enhance – the incomes of all existing dairy farmers.

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actually in the 20% range. Non-Grade AA butter supplies are thus more significant than was believed at the hearing.

35. From this premise, they argue that it is against public policy for consumers to obtain "reliable supplies of milk at the cheapest possible prices." These groups have, however, stood congressional policy on its head. Dairy legislation was not enacted solely for the economic benefit of dairy farmers. Rather, dairy legislation was intended to provide minimum prices high enough to ensure "reliable supplies of milk" *but no higher.* One need go no farther than the text of the oft-cited § 608c(18) to discern this intent. That provision directs the Secretary to set minimum milk prices at levels he finds will "insure a sufficient quantity of pure and wholesome milk." There is not a hint of an intent to benefit producers, except to the extent necessary to assure supply. Rather, the clear intent of Congress was that the Secretary set prices adequate to provide a reliable supply of fresh milk to the public. In sum, contrary to the position taken by those that oppose the butterfat price adjustment, the AMAA is not, and has never been, a dairy farmer entitlement program. Rather, the statute was intended to ensure the public an adequate supply of wholesome milk in the public interest.

(2) The Need to Avoid Disorderly Marketing

36. One of USDA's chief tasks in setting minimum prices and pooling the regional proceeds of milk is to prevent disorderly marketing. 7 U.S.C.A. § 602(1) (1999). USDA went to great lengths in the federal order reform process to set a Class II price at a specified level (70 cents per cwt) above the Class IV price. Indeed a portion of the 70 cent differential is even allocated to the butterfat portion of the price ($0.007 added to the butterfat price for Class IV). This linkage according to USDA is necessarily limited by the ability to substitute dry products for raw milk. The cost of such reconstitution then becomes the limiting factor for pricing Class II above Class IV with a 70 cent differential. However, adoption of proposal number 8 would create an additional 6 cent difference in the value of the butterfat used in Class II versus Class

IV. Relative to a load of cream which is processed as Class IV, this would increase the cost of a Class II load of cream by $1,200; this is not a cost that can be passed on to anyone. Tr. 803 line 25 through Tr. 804, line 2.

37. A number of witnesses testified that this $1,200 price difference would create several problems each of which constitutes a disorderly marketing condition. Tr. 803, line 20 through Tr. 804, line 2; Tr. 811, line 17 through Tr. 812, line 4; and Tr. 823, lines 5-11. First, it would increase the costs to regulated plants processing Class II versus unregulated or state regulated plants. This would mean that Class II operations would likely choose to alter their pool status on a month to month basis, where possible. Such pooling and depooling of milk has long been considered to be a disorderly marketing condition. Tr. 1350, line 20 through Tr. 1351, line 7 and 64 Fed. Reg. 16026 supra at 16102, c.3. The depooling of milk also leads to unreliable statistics maintained by USDA since USDA no longer has an accurate picture of milk marketing in a given region.

38. Another disorderly marketing condition is that there are plants which either cannot choose on a month to month basis whether to pool, or find that the choice of whether the milk they receive is pool milk is made by another party. This puts the plant of first receipt at a disadvantage as compared to a stand alone non-pool operation not having to incur the higher cost. Tr. 1351, lines 2-7.

39. There was also testimony by the witness for an Iowa based ice cream operation that the majority of surplus cream purchased by it already comes from California. The witness for this company said that they would look to expand that relationship with California if something happened to further exacerbate the cream pricing between Class II and Class IV. Tr. 1382, lines 5-12. USDA cannot and indeed should not ignore the reality that California's system

poses with respect to differences in pricing of products. To increase the economic benefits of such transactions is a disorderly marketing condition in and of itself.

40. Counsel for Dairy Farmers of America's putative objections to this witnesses conclusions concerning short term and long term disruptions are not relevant or well taken. In the short run, decisions concerning pooling or purchase or sale of California produced cream will be made based upon small price differences. In the longer run, with a permanent price difference for butter used in Class II or Class III versus Class IV, there will be other decisions, such as product substitution that can and will be made. Tr. 1336, lines 10-15. All of these decisions will adversely affect marketing conditions and constitute disorderly marketing conditions.

41. Next, the existence of whole milk powder as an alternative source of supply creates a new economic decision regarding product substitution with respect to adoption of proposal number 8. Such powder can be made with various quantities of fat so that one doesn't remove the fat in the first place before reconstituting. Testimony of Ms. Ledman, the expert witness, indicated that such powders would become viable alternatives should USDA adopt proposal number 8 instead of proposal number 3. Tr. 1367, lines 5–25. Other witnesses testified about this substitution effect. Tr. 1375, lines 14-20 and Tr. 313, line 22 through Tr. 314, line 18.

43. Furthermore, the expert witness testified without contradiction by any other witness, that California's 3.9 cent difference on butterfat in Class 2 and Class 3 can alone cause disorderly marketing conditions in a national market for cream. Tr. 1371, lines 10-15.

44. Finally, adoption of proposal 8, and not proposal number 3, would change a Class II handler's real life competitive costs relative to a Class IV handler, not represented by the Class II regulated price, including a new competitive relationship in attracting milk to butter that does not presently exist. Tr. 1363, line 21 through Tr. 1364, line 4. In the opinion of the one witness,

when making a regulatory decision, USDA should consider real life competitive consequences of its regulated decision. Those consequences can give rise to disorderly marketing conditions. Tr. 1364, lines 5-12. To see why this is so, USDA should consider the implications on marketing conditions when a load of cream will now cost approximately $1,200 more to a plant of first receipt if the use to which that milk is put is Class II and not Class IV. The butter manufacturer effectively gains $1,200 relative to Class II or Class III users in attracting that milk supply to its plant in competition with processors of Class II or Class III products. This will alter competitive relationships.

45. USDA cannot ignore the consequences of its previous actions that altered the skim value of milk based upon use in cheese or non-fat dry milk. The Class III-A Tentative Final Decisions resulted in myriad litigation and as predicted caused milk to flow to Class III-A uses. See, e.g., Dairymen, Inc. v. Madigan, Memorandum Opinion and Order (W.D. Ky. August 4, 1992). By increasing the competitive advantage of shipping cream to butter, USDA would either cause the price of cream used to produce butter to fall and prices of other products to rise in order to pay for increased costs of procuring the cream, Tr. 801, lines 20-23; Tr. 1335, line 22 through 1336, line 3; and Tr. 1375, lines 8-13, or USDA would cause increased production of butter or USDA would cause a combination of the these events.

46. Moreover, the testimony of the witness for the proprietary butter operation in favor of proposal number 8 demonstrates how illogical it would be to adjust the butterfat price for Class IV alone, in light of the reality of today's marketplace.

47. He testified that butter makers need a regulatory cost advantage in order to compete against Class II and III processors for bulk cream. Tr. 1833, lines 2-9. In so making this argument, the butter manufacturer, though advocating for proposal number 8, corroborated

the testimony of expert witness Mary Keough Ledman, who explained that proposal number 8 would foster disorderly marketing conditions by encouraging bulk cream sellers to sell to Class IV outlets. Tr. 1335, lines 22-24.

48. Significantly however, the butter manufacturer, somewhat in contrast to his earlier testimony that his product prices were so closely tied to his input prices that he needed a regulatory price break vis-à-vis Class II and III processors, admitted that butter plants are not always residual users of cream. In support of his statement, he explained that over the past two years butter sales grew by approximately 10 – 15%. He also does not view his company as a residual user of cream. Tr. 1836, lines 4-6.

49. These seemingly incongruous statements serve to reflect the convergence of the old and the new. Though butter may have been a residual user of cream at one time, the reality of the marketplace is that butter is no longer relegated to residual use status, and instead has carved out a market whereby there is growing demand for butter. Moreover, butter products can and do generate value-added revenue. According special treatment to butter makers would therefore be unjustified in today's marketplace, particularly in light of the fact that such special treatment will necessarily foster disorderly marketing of cream.

50. Additionally, arguments that butter operations cannot compete with the higher multiples paid by Class II and III processors are belied by the fact that cream sellers are not always able to obtain higher multiples from Class II and III customers. In particular, the Class II and III market is not always accessible to the cream seller due to, (a) transportation costs, which may create a different incentive for the sale of the cream, or (b) the existence of unregulated milk supplies, which may have a cost advantage. Tr. 1382.

51. Ironically, if USDA were to adopt proposal number 8 dairy farmers would necessarily receive less for their milk sales allocated to Class IV, but as usual, there would be no mechanism put in place to insure that higher-valued use classifications are first assured of receiving needed milk or cream which would bring forth the higher return for dairy farmers.

52. The only witness to testify concerning his day to day sales of excess cream in the marketplace and the impact of creating a different Class II, III and IV butterfat value was a witness for Suiza Foods Corporation. His testimony establishes the need to address all three classes of butterfat value:

> Suiza buys raw milk from dairy farmers and/or their cooperatives, which typically contain about 3.6 percent butterfat. Our Class I finished products generally contain less than 2.5 percent butterfat. Therefore, we have cream left over which is typically sold in 5,800 gallon bulk tankers. It's my job to market this bulk cream.
>
> My goal is to market this bulk cream to at least cover all related costs, which include the raw product cost of sale, the cost of pasteurizing/processing the cream, the cost of pumping the cream in and out of storage tanks, shrinkage, transportation cost and related administrative costs, which would increase dramatically if Proposal No. 8 is adopted.
>
> Suiza, like other industry cream sellers, has historically sold bulk cream to combinations of Class II, III and IV processors at prices based off the former Grade A butter price and later the equivalent Grade A butter price. Prior to the final rule, butterfat prices for Class II, and III and IV were practically identical, and, therefore, the cost of transportation between shipping and receiving plants was the largest decision factor for cream sellers.
>
> Proposal 8 would create a large cost wedge between Class IV and II, which would immediately complicate and increase the cost of marketing bulk cream.
>
> . . . . .

> Correcting the butterfat value for Class IV but not for Class II would have the unintended consequence of undermining this essential relationship. Thus, the only debate between proponents of Proposal No. 3 and No. 8 seems to be the extent to which this oversight should be corrected.
>
> Beyond our concern that Proposal No. 8 would distort the Class II and IV price relationship, we believe Proposal No. 8, if adopted, would force me to move cream in inefficient ways. The experts would call this disorderly marketing.
>
> In particular, if the butterfat adjustment is simply limited to Class IV, you can bet that I and other cream sellers are going to compete to sell as much cream as possible to Class IV processors. I think it's logical to conclude that as more cream is offered to Class IV processors that Class IV processors will react by lowering the price they pay for bulk cream, so instead of Proposal No. 8 correcting the problem fluid processors have been facing since January, 2000, Proposal 8 would only put Class IV processors in a superior negotiating position to procure bulk cream from fluid processors.
>
> Accordingly, the problem for my company, which was created by the final decision's butterfat formula, will only be worse if Proposal 8 is adopted in lieu of Proposal 3. In fact, Proposal 8 could lead to fluid processors being forced to avoid generating bulk cream by purchasing raw milk from dairy producers with butterfat contents that match fluid processors' finished products, e.g., 2.5 percent butterfat.

53. The uncontroverted testimony of Ms. Ledman, the qualified expert witness, is most instructive and best summarizes the nature of the disorderly marketing conditions which will result if proposal number 8 is adopted and proposal number 3 is not (Tr. 1335, line 15 through Tr. 1336, line 25):

> The question that seems to remain is to which of the minimum price formulas should the butter fat price adjustment be applied? As an economist, I cannot justify proposal eight. Proposal eight limits the proposed adjustment to the Class IV butter fat price. Doing so would create disorderly marketing. In particular, proposal eight would set up signals that interfere with normal market forces. In my opinion, at least in the short term, Class I processors with bulk cream to sell will buy for the Class IV

> customers to the exclusion of Class II and III customers. This may work well for those that are fortunate enough to secure Class IV customers, but in the short term it will place other Class I processors selling cream to Class II and III processors at an economic disadvantage.
>
> In addition, it is my opinion proposal eight will create problems over the long term as well. To the extent that Class I processors will prefer Class IV customers to Class II and III customers, the Class II and III processors will be forced to pay even higher prices to draw bulk cream away from Class IV facilities.
>
> This could have unintended business consequences for Class II and III processors. Moreover, during a tight butter market as experienced in 1998 and 1999, cream costs could reach high enough levels for these processors to employ butter substitutes. None of these results will be good for the industry.
>
> Moreover, proposal eight would disrupt the essential price relationship between Class II and Class IV. USDA determined in the final rule that a 70 cent per hundredweight differential between Class II and Class IV was appropriate before product substitution began. During the first two months of this year proposal eight would have increased the 70 cent per hundredweight differential between Class II and Class IV prices to 93 cents per hundredweight, thus providing Class II processors with the incentive to seek other alternatives.

C. Objections and Expert Witness Status

54. Objections to consideration of proposal number 3 are not well founded. Tr. 310, line 23 through Tr. 312, line 14. It has been suggested that proposal number 3 was outside the scope of the hearing because USDA was directed by Congress to consider proposals concerning the Make Allowances in Class III and Class IV. USDA, however, properly noticed proposal number 3 for consideration at this hearing. Tr., 343, lines 5-15. USDA has correctly concluded that there is a legal and logical relationship between proposals which address the value of butterfat in Class IV and in Class II. If the price formulas for Class III and IV are open for

consideration (and they are), then butterfat values in Class III and Class IV are open for consideration. Tr. 344, line 13-25. However, it is impossible to address consideration of Class IV values without taking into account the impact on Class II pricing insofar as USDA has previously concluded, correctly, that Class II and IV pricing are inextricably linked. 63 F.R. 4882 (Jan 30, 1998). Moreover, objections to proposal number 3 appear to conclude that USDA could not, on its own initiative expand the hearing beyond that required to be considered by Congress in order to provide USDA with the opportunity to address all issues necessary to reach a full and complete decision. Nothing in the 1999 budget legislation, which imposed Option 1A on the industry and mandated a make allowance hearing, negated USDA's already existing hearing powers. USDA was and is entitled to hold regulatory hearings as it deems are required to fulfill the mandate of the AMAA.

55. Finally, there was proffered, and Honorable Judge Hunt admitted, the testimony of Mary Keough Ledman as that of an expert witness in the area of dairy price forecasting and dairy policy analysis. Tr. p. 1329-1330. While the Federal Rules of evidence are not strictly applicable in administrative rulemaking proceedings, they can be useful in administrative hearing settings. *Veg-Matic, Inc. v. United States Department of Agriculture,* 832 F.2d 601, 606 (D.C. Cir. 1987); *see e.g.*, 3 K. Davis, Administrative Law Treatise § 16.5 (1980). According to Federal Rule of Evidence 703,[3] therefore, the expert status of Ms. Keough Ledman's testimony requires that Ms. Keough Ledman's opinions regarding data or information presented during the hearing or data or information obtained from sources other than Ms. Keough Ledman's firsthand

[3] FRE 703 provides as follows: "**Bases of Opinion Testimony by Experts.** The facts or data in the particular case upon which an expert bases an opinion or inference may be those perceived by or made known to the expert at or before the hearing. If of a type reasonably relied upon by experts in the particular field in forming opinions or inferences upon the subject, the facts or data need not be admissible in evidence."

observations shall be given due consideration by the decisionmakers.[4] On the other hand, Federal Rule of Evidence 701,[5] relating to the opinion testimony of witnesses who have not been qualified as experts, indicates that opinions that are not based on their first hand observations shall not be considered by the ultimate decisionmaker. Wright, C. and Gold, V., 29 Federal Practice and Procedure § 6253 at p. 118 (2000). Thus, for example, when Ms. Ledman expressed her opinion regarding the reason grade AA butter was incorporated into the most recent butterfat price formula, instead of a grade A equivalent, the Federal Rules of Evidence would require the decisionmaker to consider this opinion.

CONCLUSION

One does not envy USDA for the task, treated by statute as an emergency to boot, of once again facing the issues of make allowances and butterfat differentials. Having been previously granted the Augean stable task of federal milk order reform, a task performed on the whole quite well, it certainly was not USDA's intention to revisit these issues. Having been forced to face them again, however, it is, unfortunately for USDA, necessary to deal with Scylla and Charybdis by insuring that the best possible answers are obtained while negotiating the never ending policital mine fields. Political considerations, however, cannot substitute for common law and common sense principles of fairness and completeness. USDA must as a ratemaker consider fully all potential rate factors, something, which with all due respect, is not accomplished by the RBCS. As to the butterfat issue, USDA should conclude that the concept of minimum pricing requires that the Grade AA price be adjusted by 6 cents on Class II, III and IV milk.

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[4] Strictly speaking the Federal Rules of Evidence speak in terms of the "trier of fact", who for these purposes is the agency, which we refer to as the "decisionmaker."

[5] FRE 701 provides as follows: "**Opinion Testimony by Lay Witnesses.** If the witness is not testifying as an expert the witness' testimony in the form of opinions or inferences is limited to those opinions or inferences which are (a) rationally based on the perception of the witness and (b) helpful to a clear understanding of the witness' testimony or the determination of a fact in issue."

Respectfully submitted,

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