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

RECEIVED

In re: )  
Milk in the Northeast and )  
Other Marketing Areas )  
)

Docket Nos. AO 14-A69, *et al.*; DA-00-03

**POST HEARING BRIEF OF THE INTERNATIONAL DAIRY FOODS ASSOCIATION**

This post-hearing brief is submitted on behalf of the International Dairy Foods Association ("IDFA"), its constituent groups, and their members. IDFA is a trade association representing processors, manufacturers, marketers, distributors, and suppliers of dairy foods, including milk, cheese, ice cream and frozen desserts. IDFA serves as an umbrella organization for three constituent groups: the Milk Industry Foundation ("MIF"), the National Cheese Institute ("NCI"), and the International Ice Cream Association ("IICA"), which together represent over 80 percent of all dairy product processing in the \$70 billion U.S. dairy foods industry. MIF has over 160 member companies that process about 90% of the fluid milk and fluid milk products consumed nationwide; NCI has over 75 member companies that manufacture more than 80% of the cheese consumed in the U.S.; and IICA has over 125 member companies that manufacture and distribute an estimated 85% of the ice cream and ice cream-related products consumed in the United States. (Yonkers (IDFA) Exh. 14 at p.1). Most of the milk bought and handled by IDFA members is purchased under the Federal milk marketing orders promulgated pursuant to the Agricultural Marketing Agreement Act of 1937 (the "AMAA"). *Id.*

These hearings were called to consider whether any changes should be made in the Class III and Class IV milk pricing formulas that were included in the final rule for the consolidation and reform of Federal milk orders and implemented on January 1, 2000 (the "final rule"). Based upon the record evidence, IDFA submits that USDA should take the following steps with respect to the various proposals that were submitted:

1. **The make allowance for cheese should not be changed.**
2. **The make allowance for dry whey should be set no lower than 15.92 cents per pound of dry whey.**
3. **The Class AA NASS butter price should be reduced by 6 cents in the product price formulas applicable to all classes.**
4. **The NASS survey of cheddar cheese prices should be expanded to include 640-pound blocks.**
5. **The adjustment to the NASS survey price of cheddar cheese in 500-lb barrels and 640-lb blocks should be reduced from 3 cents per pound of cheese to 1 cent per pound of cheese.**
6. **The NASS product price surveys should be made mandatory and audited, or at least verified.**
7. **The Department should issue a recommended decision followed by a period for written comments prior to issuing a final decision in this proceeding.**

**I. THE CRITICAL IMPORTANCE OF MAKE ALLOWANCES IN A PRICING SYSTEM BASED UPON PRODUCT PRICE FORMULAS.**

The final rule utilizes the price of finished products to determine the minimum milk prices that must be paid to farmers, through a mechanism commonly referred to as a "product price formula." A product price formula sets the minimum prices that farmers must be paid for their milk (at least by proprietary handlers) as the price handlers receive for their finished products (such as cheese or butter) minus the costs the handlers incur in turning farm milk into those finished products (commonly referred to as the "make allowance"). (Yonkers (IDFA) , Exh. 14 at p. 3 ).

There is a tremendous, qualitative difference between setting a make allowance that is too "low" ( one that is less than the true costs of manufacturing) and setting a make allowance that is too "high" (one that is more than the true cost of manufacturing). Setting a make allowance that is too low has the immediate, inherent and inescapable effect of imperiling necessary investment in manufacturing facilities, while setting a make allowance that is too high can and will be corrected by the marketplace, to the satisfaction of producers and handlers. (Yonkers (IDFA) , Exh. 14 at pp. 4-5).

Specifically,

- a make allowance that is too low will make it uneconomical for proprietary handlers to operate manufacturing facilities;
- a make allowance that is too low will make it impossible for proprietary handlers to compete with plants not regulated by federal orders, especially those in California;
- a make allowance that is too low will make it impossible for proprietary handlers to compete with cooperative handlers, who can escape the impact of too low a make allowance;
- by contrast, a make allowance that is too high can and will be addressed through the marketplace by way of competitive over-order premiums on milk. (Yonkers (IDFA) , Exh. 14 at p. 5).

**A. The Role Of Make Allowances Under The New Product Price Formulas.**

In general terms, a make allowance is the difference between the wholesale sales value of a manufactured dairy product and the cost to purchase the raw milk necessary for that product's production. This make allowance is used for many

economic purposes, e.g. to pay for the use of the capital necessary to build and maintain the plant, to cover the non-milk costs relating to obtaining raw milk, to pay for marketing the processed dairy product, to pay wages to employees of the manufacturing plant, to pay utility companies for the water, electricity and natural gas used to manufacture the dairy product, to buy ingredients other than raw milk, and to cover a wide variety of other expenses such as plant maintenance, equipment, and insurance. (Yonkers (IDFA) , Exh. 14 at pp. 5-6).

A hypothetical, but realistic example, may help explain the concept of make allowances in product price formulas. Assume the example where the wholesale price of cheese is \$1.27 per pound and the total costs of manufacturing and marketing that cheese is 17 cents per pound of cheese. A manufacturing plant facing these assumed economic factors would be able to pay up to \$1.10 (\$1.27 minus \$0.17) for the raw milk needed to manufacture each pound of cheese. (Yonkers (IDFA) , Exh. 14 at p. 6).

What if this hypothetical plant is regulated under a federal order? If the make allowance specified in the regulated minimum price is 17 cents, this example plant can pay all the costs associated with manufacturing and marketing cheese after paying the regulated minimum milk price to the milk producers supplying the raw milk.

If, on the other hand, the make allowance specified in the regulations were 15 cents, the plant would be required to pay a minimum price of \$1.12 (\$1.27 minus \$0.15) to milk producers supplying milk. In this scenario, the plant would still receive the wholesale cheese price of \$1.27, but after being required to pay the minimum milk price of \$1.12 would only have 15 cents left to cover the total costs of turning that milk into cheese. But with actual total costs of manufacturing and marketing cheese of 17 cents,

the plant would be unable to pay for one or more factors of manufacturing and marketing. Obviously the plant could not continue to operate like this for any extended period of time. (Yonkers (IDFA), Exh. 14 at pp. 6-7; Reinke (Kraft) , p. 1039).

It is easy to see through this simple but accurate example the critical need for a make allowance that covers the total costs of turning raw milk into a finished dairy product, including marketing that product. Without an adequate level of make allowance, a manufacturing plant could not continue to operate, as it would have insufficient funds available to pay the vital costs necessary for operating the plant. (Yonkers (IDFA) , Exh. 14 at p. 7).

The final rule included the following observation (64 Fed. Reg. 16096):

Both handler and producer interests argued that failure to cover processors' costs of converting milk to finished products results in a disincentive to produce finished dairy products. They expressed concern that the disincentive would discourage investment in the manufacturing sector, leading to reduced manufacturing capacity and reduced outlets for producers' milk.

This observation is absolutely correct, and IDFA is aware of no economic theory or analysis that could lead to any other conclusion. (Yonkers (IDFA) , Exh. 14 at p. 7).

Now, an observer might ask, if the manufacturing plant is not, in our example, getting enough money to cover its costs, why doesn't it simply raise its prices for its finished products, or lower the amount it is paying for its milk? In our example, the manufacturer is losing 2 cents for every pound of cheese that it is selling for \$1.27; why doesn't it just raise its prices to \$1.29, or lower what it is paying for milk by 2 cents, in order to make up for the shortfall?

In an unregulated market, that would make perfect sense. The manufacturer would do one of two things—it would either raise the wholesale price of its products, or find a less costly source of raw milk.

But of course, we know that under the federal order system the handler cannot reduce what it is paying its farmers below the minimum regulated price. This option is a non-starter. (That is at least true for proprietary handlers; IDFA will get to cooperative-owned manufacturing plants in a minute.)

What is equally important to recognize is that the handler cannot escape from its conundrum by raising its finished product prices, either. We can see why this is so by returning to our example. Recall that the handler is selling cheese for \$1.27, the make allowance is 15 cents, and the minimum price of milk is therefore \$1.12. The handler is losing 2 cents for every pound of cheese it makes because its true costs of manufacturing is 17 cents, but it only has 15 cents left over after it pays for its milk. (Yonkers (IDFA) , Exh. 14 at pp. 7-8).

So why can't the handler simply raise its price to \$1.29? The problem lies in the federal order minimum price formula. As previously noted, the minimum price is the price of the finished product minus the make allowance. In our example, before any finished product price increase, the minimum milk price was \$1.27 minus 0.15 equals \$1.12. After the finished product price increase, the minimum milk price is \$1.29 minus 0.15 equals \$1.14. Thus, **all of the money derived from the increase in the finished product price has gone directly to the farmer, in the form of a higher, legally mandated minimum milk price. None of the money derived from the finished product price increase has gone to the handler.** After paying the now higher minimum milk price, the handler only has 15 cents left over—precisely the same amount as before it raised its finished product prices. (Yonkers (IDFA) , Exh. 14 at p. 8-9).

The only rational conclusion is simple and straightforward: too low a make allowance will lead to reduced manufacturing capacity and reduced outlets for producer milk. USDA must avoid setting a make allowance that is too low. To achieve that result, it must err on the side of a higher rather than lower make allowance. This is especially true given the only remedy available should costs of manufacturing increase, even temporarily, which is to petition USDA to conduct a hearing to consider changing the make allowance. For example, the increase in recent months in oil prices has likely increased the energy costs associated with operating a manufacturing plant. If handlers has requested a hearing to ask that this cost increase be reflected in the make allowances, it would likely taken more than a year to conduct a hearing, publish a decision, and implement any change. (Yonkers (IDFA) , Exh. 14 at pp. 9-10).

**B. De-pooling Is Not a Viable Option.**

In the hearing notice, USDA points out that a handler whose operations have been rendered uneconomical by an unduly low make allowance could exercise its legal right to de-pool, and thus escape from the minimum milk price requirements of the federal order system. USDA in the notice solicited comments on this issue. A simple analysis readily demonstrates that the economic opportunity to de-pool is largely illusory and cannot possibly provide a means of overcoming the disastrous impacts that will flow from too low a make allowance. (Yonkers (IDFA) , Exh. 14 at p. 7).

To understand why, one must examine the benefits that accrue to a handler by being a regulated plant. The following example uses actual prices for March 2000, as set forth in USDA's Dairy Market News for April 7 and 21, 2000. Those publications report that the Class III price in March was \$9.54, while the all-markets weighted

average statistical uniform price (the blend price under the old pricing system) was \$11.59. (Yonkers (IDFA) , Exh. 14 at pp. 10-11).

For example, if this were a single federal order market, the Class III handler is entitled to draw \$2.05 per hundredweight from the producer settlement fund (\$11.59 minus \$9.54) to pay its farmers, on top of the \$9.54 that it must pay itself. Of course, the entire \$2.05 must be paid directly to this handler's shippers, and federal order auditors will ensure that it does. (Yonkers (IDFA) , Exh. 14 at p. 11).

While it is true that de-pooling would free the plant of any legal requirement to pay the minimum price for Class III milk, the effect of de-pooling would be that the plant would no longer receive a pool draw from the producer settlement fund. Thus, the plant would be at an immediate \$2.05 per hundredweight competitive disadvantage in competing for a milk supply against all other possible outlets for raw milk. The handler would either have to find some farmers who were willing to accept a price more than two dollars below the market price—an impossible scenario—or come up with the money out of its own pocket. (Yonkers (IDFA) , Exh. 14 at p. 11).

But of course, under this scenario, no cheese manufacturer would have any money left in its pocket. In order to pay a price competitive with other outlets for milk, its raw milk costs in March 2000 would be at least \$11.59 per hundredweight, or roughly \$1.16 per pound of cheese. That cost, standing alone, exceeds the price the handler can get for its cheese, which as reported by AMS in March averaged \$1.11 per pound for cheddar cheese. The handler will have received 5 cents less than the cost of its milk even before paying for the costs of manufacturing. Moreover, competition from non-pool cheese plants would prevent it from raising its finished product prices. De-pooling



is simply out of the question. (Yonkers (IDFA) , Exh. 14 at pp. 11-12); W. Schanback (Friendship Dairies), pp. 1633-34).

The same conclusion is reached no matter what individual market is selected for examination. Take the order with the lowest Class I and highest Class III utilization, the Chicago market. For the month of March 2000, the weighted average statistical uniform price was \$10.18, meaning that Class III handlers drew 64 cents from the pool (\$10.18 minus the Class III price of \$9.54). A handler dropping out of the pool would give up the right to that draw. Perhaps a handler could find suppliers willing to supply milk for a little less than the blend price, or from time to time sell milk at a lower cost during periods of temporary oversupply. But 64 cents—or 6.3%-- less, over a sustained period, is not possible. (Yonkers (IDFA) , Exh. 14 at p. 12).

Moreover, the option to de-pool is substantially less attractive than in the past due to two regulatory changes that took effect on January 1, 2000. First, consolidation has caused some marketing areas that used to have low Class I utilization to be part of much larger orders with much higher Class I utilization. This is clearly evident in the former marketing area of Southwestern Idaho - Eastern Oregon. The Class I use in February was only 11.3% in 1998 and a mere 5.0% in 1999. But this area is now part of the consolidated Western marketing area, with a Class I use of 27.6% in February 2000. The higher Class I utilization of course leads to a larger spread between the uniform price and the Class III price. Because de-pooling causes a handler to lose its right to draw that "spread" from the producer settlement fund, de-pooling becomes particularly unattractive. (Yonkers (IDFA) , Exh. 14 at p. 12-13).

Second, although the Class I price under the former pricing system was the sum of the Class I differential and the Class III price, it is now the sum of the Class I differential and the higher of the advanced Class III or Class IV price. The difference between the Class I price and the Class III price will be greater under the new system in those months in which the advanced Class IV skim price is higher than the advanced Class III skim price. This will also cause the spread to increase between the uniform price and the Class III price, again making de-pooling unattractive. (Yonkers (IDFA) , Exh. 14 at p. 13).

**C. Too Low a Make Allowance Will Cause Production to Shift to Non Federally Regulated Areas.**

The foregoing analysis demonstrates that setting too low a make allowance will cause production of manufactured products to be uneconomical, resulting in disinvestment in processing facilities as a direct and sole result of this regulatory pricing formula error. But that analysis of course only holds true for those plants that are subject to federal minimum milk price requirements.

The largest state in terms of milk production, California, is not covered by a federal order, but instead relies on state regulation of milk pricing. The importance of California's milk production and dairy product production cannot be overstated in analyzing the impact of changes in federal order regulations. California has consistently chosen to maintain a state-regulated milk pricing system. Historically, California has regulated minimum prices at levels below federal order minimums and yet, as demonstrated by the statistics which follow, milk production and dairy processing have flourished. Past attempts to legislatively mandate California to regulate price at higher levels were flawed economically and were ultimately rejected. Consequently, since

California is not subject to federal order minimum milk price regulation, nor is there economic justification to force California to regulate milk prices at higher levels, the relationship between California milk and dairy product prices and federal order regulation is critical. While both raw milk and dairy product production have increased in both California and the U.S. as a whole, the increases for California are staggering. (Yonkers (IDFA) , Exh. 14 at pp. 13-14).

Between 1980 and 1999, total milk production in the U.S. increased by 27%, but total milk production in California increased by 124%; during this period, California's share of U.S. total milk production increased from 10.6% in 1980 to 18.7% in 1999. The trend in dairy product production is even more pronounced. Between 1980 and 1999, the production of all cheese in the U.S. increased by 99%, but in California all cheese production increased by 662%. This resulted in California's share of all cheese production in the U.S. increasing from 4.6% in 1980 to 17.4% in 1999. California's share of total U.S. nonfat dry milk production increased from 20.9% in 1980 to 47.2% in 1999, and its share of U.S. butter production increased from 16.1% to 26.9% during the same period. (Yonkers (IDFA) , Exh. 14 at p. 14).

Clearly, USDA cannot ignore the impact on the U.S. dairy market of dairy products that are manufactured in plants not regulated by federal orders. USDA recognized this in the hearing notice, when it noted that "prices paid for manufactured milk under federal orders cannot get too far out of alignment with the value of milk for manufacturing in the rest of the United States." (Yonkers (IDFA) , Exh. 14 at p. 15).

The current make allowances have resulted in greater alignment between federal order and California minimum prices for milk used in manufactured dairy products.

(Williams (Glanbia) pp. 1296-99). Lowering the federal order make allowances would return this price relationship toward pre-2000 levels, which was cited by several hearing participants as a major force resulting in California manufactured dairy product production outpacing that of the rest of the US. (Dryer (Saputo) p. 1326; Gran (Family Dairies USA) p. 1448).

A comparison of prices paid for milk used in manufactured dairy products between federal orders and California shows that, on average, federal order prices are already higher than those in California. For the 19-month period beginning with September 1998 (when the NASS survey data now used to calculate federal minimum price first became available), the current federal order product price formula would have yielded an average Class III minimum price of \$12.82 and an average Class IV minimum price of \$12.87, both for milk with 3.5% butterfat. The equivalent California minimum regulated prices for milk used to make similar dairy products for the same 19-month period were \$12.75 and \$12.77, respectively. Thus, the federal order prices already exceed the California prices by 7 cents for federal order Class III and by 10 cents for federal order Class IV. (Yonkers (IDFA) , Exh. 14 at p. 15).

The Notice of Hearing calculates that the proposal to lower the make allowance on cheese from its current 17.02 cents per pound to 14.2 cents would cause the Class III price to increase by 21.2 cents per hundredweight. Such an increase, or anything like it, in the already meaningful disparity between federal order and California prices is simply not sustainable. (Yonkers (IDFA) , Exh. 14 at p. 15).

**D. Too Low a Make Allowance Will Cause Production to Shift to Cooperative-owned Processing Plants.**

Cooperative associations regulated by federal orders have the legal right to distribute the proceeds of their marketing and operations however the cooperative association deems appropriate. To put it another way, cooperative associations are not required to pay the minimum price for milk. Thus, these types of manufacturing plants are able to adjust for an improperly-set (too low) make allowance by paying milk producers less than the minimum price specified by the federal order. (Yonkers (IDFA) , Exh. 14 at p. 16).

Return to our example of a cheese price of \$1.27 per pound, a make allowance of 15 cents, a resulting minimum milk price of \$1.12 per pound, and actual cost of manufacturing of 17 cents. We have already seen that the proprietary cheese manufacturer suffers a loss of 2 cents per pound of cheese manufactured, and that no mechanism exists by which it can recoup this loss. But a cooperative manufacturer in the same position need not pay its farmer members the \$1.12 per pound for their milk; it can instead lower the price to them to the \$1.10 needed to reduce its losses to zero. (Yonkers (IDFA) , Exh. 14 at p. 17).

The cooperative could instead choose to pay the federal minimum price and finish its operating year with a net loss, which will then be apportioned to the milk producer members in either an assessment or a reduction in member equity. This merely is a matter of accounting, and the bottom line is the same. (McDowell (USDA), p. 182). The cooperative will have kept its plant operating in an economically rational basis, and unlike the proprietary handler, will not be forced to dis-invest as the sole result of a misguided regulatory pricing formula. (Yonkers (IDFA), Exh. 14 at p. 17).

In fact, USDA acknowledged this distinction between cooperatives and proprietary handlers in the hearing notice, stating " it is assumed that these proposals will have a lesser effect on farm prices and receipts of member milk processed and marketed by cooperatives than on prices and receipts of milk manufactured by proprietary processors. A baseline assumption is that a cooperative passes through to its members the best price and best return on investment that it can. A higher minimum federal order price could result in cooperative paying higher monthly prices for milk, but would result in lower returns on investments paid at the end of the year." IDFA endorses this USDA analysis, and its conclusion that "Total cash receipts for member milk marketings processed by the cooperative would be changed only by changes in wholesale product prices."

While the short term result of specifying the make allowance too low is likely to be less available plant capacity, the longer run result is that an increasing share of the U.S. production of manufactured dairy products will shift either to plants owned and operated by cooperative associations, or to areas where federal order regulation is either non-existent or not as much of a factor in determining the competitive value of raw milk. In either case, milk producers' share of the wholesale sales value of manufactured dairy products is not likely to change, as the very reason for such a structural shift in dairy product manufacturing is to avoid the too-high minimum milk price resulting from specifying a too-low make allowance. (Yonkers (IDFA), Exh. 14 at p. 18); M. Scheinback (Friendship Dairies), p. 847; Dryer (Saputo) p. 1326).

It is likely that, in federal order areas, the market would continue to clear only through plants owned and operated by cooperative associations. In effect, these

processing cooperatives would be balancing the market, with the entire expense of doing so placed on their member milk producers. Member milk producers of bargaining cooperative associations without processing plants would not directly bear this cost.

IDFA is not alone in reaching these conclusions regarding the deleterious impact of too low a make allowance. In his recent article and in his live testimony at the hearings, Mark Stephenson of Cornell University emphasized that "the real danger in regulating minimum prices is to regulate a price that is too high." (Exh. 29). Dr. Stephenson goes on to say "If processors must pay more than a market clearing price, they will not want to buy as much milk as is available. Farmers then may be left with unsold milk, or their cooperatives will be forced to find outlets for distressed sales of milk. This would constitute one form of disorderly marketing - something federal orders are supposed to prevent." (Exh. 29).

**E. The impact of specifying a too-high make allowance in federal orders is corrected by the market.**

In contrast to the severe and negative impacts of specifying too-low a make allowance in federal orders, a too-high make allowance (that is, one that is in excess of the true costs of manufacturing) would have much less influence on the structure of dairy markets. This is largely a function of the role of minimum price regulation in federal orders, where plants can, and often do, pay more than the minimum price for raw milk used to make manufactured dairy products. (Yonkers (IDFA) , Exh. 14 at p. 19).

For plants owned and operated by cooperative associations, a too-high make allowance makes no difference in the ultimate price delivered to milk producer members for raw milk. As an example, if the cheese make allowance were hypothetically set too

high, say 20 cents versus a 17-cent actual total costs of manufacturing, the cooperative association would return the extra 3 cents per pound of cheese manufactured to its milk producer members, either in the form of an over-order premium or at the end of the year when operating returns are distributed. (Yonkers (IDFA) , Exh. 14 at pp. 19-20).

For those plants not operated by a cooperative association, competitive market conditions would influence the level of over-order premiums paid above the federal order minimum price. The existence of market over-order premiums for Class III milk in several areas of the country was confirmed by hearing testimony. (Hollon (DFA) pp. 1575-78; Williams (Glanbia) p. 1296).

Cooperative associations, as already discussed, would pass all of the wholesale sales value of dairy products in excess of that needed to cover the total costs of manufacturing to their milk producer members. Since cooperative associations are significant players in the manufacturing of dairy products (76% of the dry milk products, 61% of the butter, 48% of the dry whey products, and 40% of the cheese produced in the U.S. in 1997 -- they are a considerable force to be reckoned with in the marketplace. In order to remain competitive in the marketplace for raw milk, a proprietary plant would have to pay an amount at least equal to the cooperative association in the above example, as an over-order premium. (Yonkers (IDFA) , Exh. 14 at p. 20).

In short, market forces will result in over order premiums that will adjust the amount being paid to farmers to reflect the fact that the make allowance was set higher than the actual cost of production. This is in keeping with the approach to minimum price regulation described by the University Study Committee (USC) that helped shape the final rule:



“While (the AMAA was) enacted a half century ago, regulatory experience indicates that minimum pricing allows latitude for market forces to operate while providing stability, orderliness and a reflection of national supply and demand conditions. In other words, USC concludes that the framers of the AMAA acted with considerable wisdom and insight which should be taken seriously in designing a substitute for the M-W price series.” (Yonkers (IDFA) , Exh. 14 at p. 20).

One commonly-made argument against setting a too-high make allowance is that, while competitive market forces will result in an over-order premium being paid to the producers supplying that plant, the added value of the raw milk input will not be pooled in the federal order and, therefore, will not be part of the total price paid to milk producers supplying other plants. This argument has no economic basis in fact. (Yonkers (IDFA) , Exh. 14 at p. 21).

Consider the following example, where a cheese plant regulated by a federal order has costs of manufacturing of 17 cents per pound of cheese, but the federal order make allowance is 20 cents per pound, and the wholesale price of cheese is \$1.27. If this is a plant owned and operated by a cooperative association, milk producer members will receive not merely the minimum price for milk of \$1.07 (\$1.27 minus \$0.20), but will also receive the 3-cent difference between the federal order make allowance and the plant’s actual costs as an over-order premium. As described above, other, non-cooperative cheese plants also would have to pay this 3-cent over-order premium for competitive market reasons. (Yonkers (IDFA) , Exh. 14 at pp. 21-22).

Furthermore, other non-cheese plants would also need to increase their over-order premium in order to compete for a raw milk supply in the market. In a federal order, all producers receive the same minimum price, regardless of which product(s) their milk is made into. In the above example, cheese plants in the federal order would be paying their milk producers the same minimum price as every other plant in the

federal order, plus the 3-cent per pound of cheese over-order premium. In order to compete for a milk supply, all other plants in the marketing area would have to pay an equivalent 3-cents per pound of cheese above the minimum price. (Yonkers (IDFA) , Exh. 14 at p. 22).

## **II. WHAT FACTORS SHOULD BE INCLUDED IN DETERMINING MAKE ALLOWANCES.**

As explored at length in Section I under product price formulas:

The Minimum milk price = finished product price minus make allowance, and therefore The Make allowance = finished product price minus minimum milk price.

In other words, product price formulas are designed to require the manufacturer to pay to the dairy farmer, in the form of a regulated minimum price, everything the processor receives for its finished product in excess of the make allowance. The processor, by definition, never gets to hold on to a penny more than the make allowance. (Yonkers (IDFA) , Exh. 14 at p. 22).

Given this purposeful design, it seems perfectly obvious that all costs that a processor incurs in taking raw milk and turning it into a finished product must be included in the make allowance. To do anything else would guarantee that a processor will never be able to cover its costs, and must dis-invest from its manufacturing facilities and activities. (Yonkers (IDFA) , Exh. 14 at pp. 22-23).

IDFA therefore strongly supports using actual industry data for costs of manufacturing as the basis for order make allowances. This must include all costs, beginning with those raw milk procurement costs not directly reflected in the price paid for the raw milk, all the way through the costs of marketing bulk commodities in the wholesale dairy market. In other words, all costs commensurate with producing,

marketing and delivering the products for which prices are gathered by the NASS Dairy Products Prices survey must be included. Failure to include any cost incurred during this process of taking raw milk and delivering a finished wholesale product would result in too-low a make allowance (whose consequences IDFA has already outlined). (Yonkers (IDFA) , Exh. 14 at p. 23).

Among the costs that must be included in the make allowance are the following:

**a. Procurement costs.** Raw milk does not magically appear at a manufacturing plant's receiving area. In addition to the price paid for the raw milk, most manufacturing plants have costs associated with insuring that a sufficient volume of milk is delivered in a timely fashion to the plant (e.g. field staff, milk assembly coordination, and shipper relations). Such costs must be included in the difference between the wholesale sales value and the price paid for raw milk if a plant is to continue to operate over time.

Several proposals for this hearing have suggested using summary data from the annual survey conducted for cooperative associations by USDA's Rural Business - Cooperative Service. IDFA will discuss latter some other problems with this data source. But the problem we will note here is that the instructions for completing that survey specifically ask that all milk procurement costs be excluded from the costs accounted for in the survey (one reason may be that, for cooperatives, some milk procurement costs such as those for field staff, are difficult to correctly apportion among the multiple functions they perform, like member relations versus milk procurement). (Yonkers (IDFA) , Exh. 14 at pp. 23-24). IDFA specifically opposes those proposals that

suggest using data that does not include this cost of obtaining raw milk, including Proposal Nos. 6, 7, 9, 10, 17, 15, 16, 21, 22, 23, 24 and 25.

**b. Marketing costs.** Another key cost which is excluded from the RBCS survey is the cost associated with marketing the finished bulk commodity. Once again, the wholesale sales value does not magically appear as soon as a dairy product is produced. Manufacturing plants have costs associated with marketing and selling their finished products, which must be covered over time if the plant is to remain in operation. (Yonkers (IDFA), Exh. 14 at pp. 24-25). Some proposals that suggest that the RBCS survey be used in determining make allowances specifically seek to include an allowance for marketing costs in the make allowances, including Proposal Nos. 6, 14, 21, and 23. However, Proposal Nos. 2, 7, 22, and 24 do not include a marketing allowance, and IDFA opposes these proposals on this basis.

**c. Cost of Capital.** The RBCS survey specifically excludes an allowance for the cost of capital invested in a manufacturing plant. But capital costs must be incurred in order to finance the construction and other non-operating aspects of the plant. In order to insure the long term economic viability of such plants, an amount sufficient to cover the cost of capital invested, whether that capital cost is the result of borrowed capital or investor capital, must be included in any determination of the costs of manufacturing used as the basis for make allowances. (Yonkers (IDFA) , Exh. 14 at p. 25). IDFA opposes those proposals that do not include an allowance to cover the cost of capital for manufacturing plants, including Proposal Nos. 6, 7, 9, 10, 14, 15, 16, 21, 22, 23, 24, and 25.

d. **Administrative Costs.** Instructions for completing the RBCS survey specifically exclude administrative costs, which are noted on the survey to include plant office costs, the plant manager wages, and corporate overhead. These are all necessary costs associated with operating a manufacturing facility. (Yonkers (IDFA) , Exh. 14 at p. 25). IDFA opposes those proposals that do not include an allowance to cover administrative costs for manufacturing plants, including Proposal Nos. 6, 7, 9, 10, 14, 15, 16, 21, 22, 23, 24, and 25.

Aside from these key aspects of the total costs of manufacturing dairy products, there appears to be little disagreement in the industry about the inclusion of most plant operating costs. These include all labor costs associated with the conversion of raw milk to finished bulk dairy products (e.g., direct plant labor costs and supervisory labor costs, all including fringe benefits); all non-labor processing costs (e.g., electricity, natural gas, water and sewer, repairs and maintenance); and all costs of ingredients other than the price paid for raw milk ingredients, and packaging.

Failure to include any of the costs described above would result in too-low a make allowance, and the disorderly marketing conditions that would follow. IDFA supports the proposals that seek to include all costs associated with taking raw milk and processing and marketing a finished dairy product in the wholesale market, including Proposal Nos. 12 and 20.

**III. THE DATA SOURCES THAT SHOULD BE USED TO DETERMINE MAKE ALLOWANCES, AND THE MAKE ALLOWANCES THAT SHOULD BE INCORPORATED INTO THE FORMULAS.**

The next step is to determine what those make allowance costs are.

One important criterion is that the cost data represent plants owned and operated by both cooperative associations and non-cooperative plants. To begin with, both types

of plants can be subject to federal order regulation, and both compete with each other regardless of whether they are regulated by the federal order system. (Yonkers (IDFA) , Exh. 14 at p. 26).

In addition, the NASS dairy products prices surveys that provide the product price data used in the product price formulas include both types of plant ownership in its survey. In order to ensure an "apples to apples" matching of prices and costs, the data used in the federal order product price formulas should make every effort to include data from the same sources. (Yonkers (IDFA) , Exh. 14 at p. 26-27).

Furthermore, manufacturing plants subject to regulation based on the make allowances used in federal orders compete with plants that are not subject to such regulation. In some cases, these may be plants that are not regulated by either federal or state milk price regulation and therefore have no regulated minimum price requirements. In other cases, these plants will be subject to state milk price regulation, which may use different make allowances. In either case, failure to include these plants in data used to determine federal order make allowances could result in a non-representative make allowance, potentially providing incentives for investments in existing and new plants and equipment outside of federal order regulation. (Yonkers (IDFA) , Exh. 14 at p. 27).

In the final rule, USDA stated that "The make allowances contained in the proposed rule were developed primarily from make allowance studies conducted at and published by Cornell University and an analysis of manufacturing plant size in relationship to the data contained in the Cornell studies. Audited cost of production data published by the California Department of Food and Agriculture was also used in

determining a reasonable level of make allowances.” IDFA notes that the Cornell studies relied on in the proposed rule were all published 1987 and 1992, and all relied on data more than 10 years old at the time the proposed rule was published in January 1998. (Yonkers (IDFA) , Exh. 14 at p. 27).

USDA then noted “Nearly all the comments received relating to make allowances asserted that the proposed rule make allowances were understated.” In the final rule, USDA substantially changed nearly all the make allowances to reflect these comments. In place of the out of date Cornell studies, USDA relied on two primary sources of data on make allowances that were identified by industry in written comments on the proposed rule.

The first was make allowance data collected and published by the California Department of Food and Agriculture (CDFA), which is part of CDFA’s ongoing milk pricing system. This data is based on audited surveys of plants which make mostly cheddar cheese, and includes costs associated with all bulk cheddar cheese package sizes, although packaging labor and packaging expenses reflect costs from only the 40-lb block cheese plants in the survey. In its final decision, USDA reported that the CDFA data supported a make allowance of 18.55 cents per pound of cheese. This was based on CDFA’s audited survey of 9 cheddar cheese plants with a total processing volume of 375.6 million pounds, for the two-year period from January 1995 through December 1996. (Yonkers (IDFA) , Exh. 14 at p. 28).

The second source of data was provided by the Rural Business Cooperative Service (RBCS) of USDA. As part of its ongoing technical assistance program to cooperatives, RBCS annually surveys cooperative dairy manufacturing plants about

costs of processing. This is not a make allowance study, but rather an effort to provide cooperative dairy plants with benchmark data for costs of manufacturing. This survey is not limited to 40-pound block cheddar cheese, but includes all sizes and packaging types (including 640-pound blocks and 500-pound barrels), and even includes data from plants which produce both cheddar and other types of cheese. However, this survey explicitly excludes the costs associated with procuring raw milk, marketing the finished dairy product, an allowance for the cost of capital invested in the plant, and even excludes the administrative costs associated with managing the plant (the plant office costs, plant manager salary and fringe benefits, and corporate overhead). (Yonkers (IDFA) , Exh. 14 at pp. 28-29).

In its final decision, USDA reported that the RBCS data supported a make allowance of 15.4 cents per pound of cheese. This was based on data provided by 4 cooperatives on 6 cheddar cheese plants with a total processing volume of 352.6 million pounds, for calendar year 1996. (Yonkers (IDFA) , Exh. 14 at p. 29).

Industry comments submitted to USDA during the reform process contained suggestions ranging from using the RBCS study alone to using the CDFA study alone to set the make allowance for cheese in the Class III product price formula. IDFA, and others, suggested using an average of the two sources of data, weighted by the volume of cheese processed. In the final rule, this suggestion was the one adopted by USDA, resulting in a make allowance for cheese of 17.02 cents per pound. (Yonkers (IDFA) , Exh. 14 at p. 29).

Since that time, CDFA has completed additional surveys of make allowances; the most recent data was published in February 2000. CDFA reported data for 9 cheese



plants, representing 466 million pounds of cheese production, with a weighted (by volume of cheese produced) average actual, total cost of manufacturing of 16.93 cents per pound of cheese. IDFA believes this data provides a very useful input for determining federal order make allowances. The volume covered by the survey is substantial; the survey does not specifically exclude non-cooperative plants; the CDFA audits all the plants in the survey; and the only costs not included in this reported are those associated with marketing the finished product. (Yonkers (IDFA) ; Exh. 14 at pp. 29-30).

The hearing included a detailed description of the manner in which the CDFA collects and carefully surveys the data for determining make allowances, including in-plant audits by trained professionals. (Schiek (Dairy Institute of California) pp. 1161-64). The CDFA data is highly reliable and should continue to be used by USDA for setting make allowances. Yonkers (IDFA) Exh. 14 at pp. 29-30; Coughlin (NMPF) pp. 194-95).

However, IDFA strongly believes that data representative of other geographic areas of the country, in addition to California, also should be used as input in determining make allowances. In the final rule, the only data available for geographic regions outside of California was the study conducted as part of a technical assistance program by the Rural Business Cooperative Service. Accordingly, USDA had little choice but to include its data. But this survey has several serious drawbacks:

- As pointed out by Ling (USDA) pp. 73-81, the RBCS survey was never intended to be used as for setting make allowances in federal order product price

formulas. The purpose was only to serve as benchmarks of in-plant costs of manufacturing.

- The Survey excludes some in-plant costs which were thought to be difficult to allocate correctly in multi-product plants. Witnesses from cooperatives participating in the RBCS survey, confirmed that such cost of manufacturing was excluded in their survey response, and confirmed that such costs were actual, legitimate expenses incurred during the process of turning milk and dairy ingredients into manufactured dairy products. (Hollon (DFA) 1594-96; Olson (AFBF) pp. 842-845; Wellington (Agrimark) pp. 1507-08). Excluded but "necessary" costs include administrative, corporate overhead, procurement, marketing, and capital. (Ling (USDA), pp. 73-81).

- Perhaps most importantly, the record evidence has established the fundamental unreliability of the RCBS data. The results of the most recent RCBS survey purport to demonstrate that the larger the cheese plant, the higher the costs of operations. (Ling (USDA) pp. 142). (This observation flows from the fact that the survey reports simple average cheese production costs that are lower than weighted average costs. (Ling (USDA), pp. 139-40; Yonkers (IDFA) , pp. 336, 469-70; Schiek (Dairy Institute of California), p. 1176).

This is completely false, because larger plants are more efficient and therefore have lower costs of manufacturing. (Ling (USDA) pp. 140-41). This is a commonly accepted economic principle. (Yonkers (IDFA) , pp. 335-36). Indeed, the RCBS data is completely inconsistent with the results of the CDFA survey described above (where the weighted average was 1.6 cents lower than the simple average) and the IDFA survey

described below.<sup>1</sup> It is also inconsistent with what the RCBS data itself reveals for butter and powder plants. (Ling (USDA), p. 141). USDA has not done anything to investigate this phenomenon (its role being limited to combining the data received from the various survey participants). (Ling (USDA), p. 146).

The RCBS data is thus inherently suspicious and unreliable. In fact, Wellington (AgriMark), pp. 1481-86 specifically described the lack of attention paid to the RBCS survey by one respondent, which resulted in under-reporting of the costs of manufacturing in this survey.

For all these reasons, USDA should not use the RBCS data for purposes of determining make allowances.

This RBCS data was the only non-California data available when the final rule was promulgated, and USDA had little choice but to use it. That is no longer the case. For the purpose of this hearing, one of IDFA's constituent organizations, the National Cheese Institute (NCI), undertook a much broader survey of cheese plants to obtain the costs of manufacturing cheddar cheese and dry whey. A survey form was developed by NCI that followed that used by the RBCS, but does not exclude costs associated with procuring raw milk, and explicitly includes the costs of marketing finished dairy products and administrative overhead (both excluded by RBCS). NCI by design did not ask for cost of capital data, because it was preferable to rely on the audited plant data from CDFA for the cost of capital, since CDFA uses a consistent method of determining the

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<sup>1</sup> A similar phenomenon was observed in California only once, during the very first year in which CDFA conducted a make allowance survey. This anomaly resulted from massive start up problems at a large newly opened cheese plant. (Schiek (Dairy Institute of California), pp. 1176-77).

total capital investment in each surveyed plant, and then uses the current prime interest rate to establish the total value of the return on capital invested. (Yonkers (IDFA) , Exh. 14 at pp. 30-31).

This NCI survey form (a copy is attached to Exhibit 14; the solicitation letter is Exh. 53) was sent to all dairy product manufacturing plants that manufacture cheddar cheese according to USDA's plant inspection list, except for those plants located in California (and thus already represented by data in the CDFA audited survey). In addition, because CDFA does not collect any data on the costs of manufacturing dry whey, the NCI whey survey included cheese plants in California that manufacture dry whey, as well as plants in other states that produce products other than cheddar cheese but do produce dry whey (these plants were only asked to provide data on dry whey). (Yonkers (IDFA) , Exh. 14 at p. 31).

All plants were asked to provide data for the most recent 12-month available, with a preference for data which had been confirmed by at least internal firm audit. Actual plant data was not reported to IDFA in order to assure the confidentiality of individual plant data. Instead, all data was submitted to a third party survey and accounting firm, Association Survey Resources (ASR), LLC of Bethesda, Maryland. At IDFA's direction, ASR checked each data item reported against the range of data reported in the 1996 RBCS survey. Any data item which was, on a per pound of cheese basis, more than 10 percent outside of the range of data reported in the 1996 RBCS report, resulted in a call from ASR to the plant contact indicated on the NCI survey form to confirm the data as reported. (Yonkers (IDFA) , Exh. 14 at pp. 31-32).

Fifteen plants (from 10 different firms) returned usable data on the cost of manufacturing cheddar cheese. Survey participants included both proprietary and cooperative owned plants. (Yonkers (IDFA) , pp. 467, 1771)(listing the participants). Seven plants (from 6 firms) responded with data on the cost of manufacturing dry whey. (Id. at 1772). Again, survey participants included both proprietary and cooperative owned plants. (Yonkers (IDFA) , p. 1772)(listing the participants).

The plants participating in the surveys came from a wide geographic range. (Yonkers (IDFA),p. 1773 (listing the areas)). The 15 cheddar cheese plants reported a total volume of cheese manufactured of 1.029 billion pounds of cheese annually, representing 36.5 percent of the total U.S. cheddar cheese production of 2.817 billion pounds reported by USDA/NASS in 1999. The weighted (by volume of cheese produced) average total cost of manufacturing for all 15 plants was 16.79 cents per pound of cheese. (Yonkers (IDFA) , Exh. 14 at p. 32).

Four hearing participants testified about their companies' participation in this survey. (Reinke (Kraft), p. 1039; Williams (Glanbia), p. 1301; Taylor (Leprino), pp. 1737-38; and Wellington (AgriMark), p. 1484).

The NCI survey also found that the cost of marketing, which is not included in either the RBCS or CDFA surveys, was 0.11 cents per pound of cheese. For the following calculation, IDFA added this 0.11 cents marketing cost to the CDFA weighted average cheese costs of manufacturing of 16.93, for a total cost of manufacturing, including marketing, of 17.04 for the CDFA data. Combining the NCI and CDFA surveys results in data from 24 cheese plants, with total combined cheese production of 1.495 billion pounds, or 53.1 percent of total U.S. cheddar cheese production in 1999.

The weighted average cost of manufacturing, including marketing costs and an allowance for cost of capital, using both these sources of data is 16.87 cents per pounds of cheese, as shown in the following chart:

Cheddar Cheese Total Costs of Manufacturing, 1999			
	CDFA Survey Weighted Average	NCI Survey Weighted Average	Combined Surveys Weighted Average
	- - - \$/lb of cheese - - -		
Miscellaneous Ingredients (non-milk)	\$0.0121	\$0.0138	\$0.0133
Packaging	\$0.0188	\$0.0103	\$0.0129
Processing - Labor	\$0.0456	\$0.0474	\$0.0468
Processing – non-labor	\$0.0636	\$0.0593	\$0.0606
General and Administrative	\$0.0190	\$0.0259	\$0.0237
<b>Total Operating Costs</b>	<b>\$0.1590</b>	<b>\$0.1565</b>	<b>\$0.1573</b>
Marketing Costs	\$0.0011	\$0.0011	\$0.0011
Cost of Capital	\$0.0103	\$0.0103	\$0.0103
<b>Total Costs of Manufacturing</b>	<b>\$0.1704</b>	<b>\$0.1679</b>	<b>\$0.1687</b>
Number of Plants	9	15	
Total Survey Volume (mil. Lbs)	466	1,029	1,495
Share of U.S. Production	16.5%	36.5%	53.1%

(Yonkers (IDFA) , Exh. 14 at p. 33-34).

Based upon these results, IDFA sees no need to change the cheese make allowance in the protein product price formula from its current level of 17.02 cents per

pound of cheese. If any change is to be made, then under no circumstances should USDA adopt as a make allowance for cheese a value lower than 16.87 cents per pound of cheese for use in the protein product price formula.

**Dry whey make allowance.** In the final rule, USDA did not rely directly on a survey of the costs of manufacturing dry whey in determining the make allowance for the other solids product price formula. USDA instead used as a surrogate for actual whey cost of manufacturing data the make allowance used for nonfat dry milk (13.7 cents).

Extensive and exhaustive expert , supplemented with specific data, confirmed that it is inappropriate to continue to utilize the cost of manufacturing nonfat dry milk as a surrogate for the cost of manufacturing dry whey. Venkatachalam (Leprino) pp. 1386-99 and Exh. 41. That expert established, without contradiction, that it costs a full 2.559 cents more to manufacture a pound of dry whey than a pound of nonfat dry milk. This is true for two basic reasons. First, raw liquid whey is approximately 94 percent water, compared to liquid skim milk which is approximately 91 percent water. The cost of removing the water from liquid whey is therefore greater than that for skim milk, because there is more to remove. Second, the manufacturing process for dry whey requires a crystallization process which is a more costly drying process than that used for nonfat dry milk, which is not crystallized. *Id.*

In the NCI survey, the 7 plants reporting costs of manufacturing for dry whey produced 307.2 million pounds of dry whey in 1999. This represents 28.4 percent of the 1.083 billion pounds of dry whey for human use produced in the U.S. in 1999, as reported by USDA/NASS. The weighted (by volume of dry whey produced) average of

the costs of manufacturing dry whey was 15.92 cents per pound of dry whey, as shown by the following chart:

Dry Whey Total Costs of Manufacturing, 1999				
				NCI
				Survey
				Weighted
				Average
Miscellaneous Ingredients (non-milk)				\$0.0080
Packaging				\$0.0082
Processing - Labor				\$0.0285
Processing - nonlabor				\$0.0778
General and Administrative				\$0.0337
<b>Total Operating Costs</b>				<b>\$0.1489</b>
Marketing Costs				\$0.0058
Cost of Capital				\$0.0103
<b>Total Costs of Manufacturing</b>				<b>\$0.1592</b>
Number of Plants				7
Total Survey Volume (mil. Lbs)				307.2
Share of U.S. Production				28.4%

(Yonkers (IDFA) , Exh. 14 at pp. 34-35). IDFA therefore proposes that USDA adopt as the make allowance for dry whey a value no lower than 15.92 cents per pound of dry whey for use in the other solids product price formula.

The combination of the CDFA and NCI survey data provides a more than sufficient—indeed, a very solid -- foundation for determining make allowances. These



data sources overcome the numerous deficiencies identified in the RBCS survey data. IDFA therefore supports the use of the CDFA and NCI data, and opposes those proposals that would base the make allowances on the RBCS survey. (Proposal Nos. 6, 7, 14, 15, 16, 21, 22, 23, and 24).

Using the weighted average make allowance data, as IDFA strongly urges, is no windfall to manufacturers. By definition, half of all production is at costs above the weighted average, and the make allowance will be insufficient to cover those plants' costs. They will have to lower their costs or otherwise improve efficiencies to remain viable over the long term. (Yonkers (IDFA) , p. 414).

#### **IV. THE CURRENT YIELD FACTORS SHOULD NOT BE INCREASED.**

As with make allowances, an inappropriate yield factor in the product price formulas can have serious and negative repercussions on plants and dairy industry structure. In the case of make allowances, the negative impacts result from a make allowance that is too low as compared to actual costs of production. In the case of yield factors, the negative impacts result from overstating the amount of dairy products that can be produced from a given unit of milk components. Such an error would overstate the wholesale sales value attributed to the yield of each component. This would cause the handler to overpay for the component, and just like a too low make allowance, cause its operations to be uneconomical. (Yonkers (IDFA) , Exh. 14 at p. 36).

The yield factors addressed by the proposals in the Notice of Hearing are those used to compute the minimum prices of protein and non-fat solids. None of these proposals should be adopted.

**A. The cheese yield factor.**

Four proposals favor changing the yield factor associated with the butterfat adjustment in the protein product price formula used in calculating the minimum price for Class III milk (Proposal Nos. 10, 11, 14, and 15). All of these proposals concern the retention of butterfat in cheddar cheese manufacturing. (Yonkers (IDFA) , Exh. 14 at p. 36).

Currently, the federal order product price formula for protein includes a multiplier of 1.582, which is based on the fact that, on average, 90 percent of the butterfat is retained in cheese during manufacturing. The other 10 percent, on average, ends up in the whey fraction, and is usually recovered as whey cream, which I am told is generally sold at a discount to sweet cream. Proposal Nos. 11, 14, and 15 all suggest using a butterfat retention of 91 percent, while Proposal No. 10 suggests a butterfat retention of 92 percent.

IDFA opposes all four of these proposals. There are two reasons why.

**1. The Yield Factor Cannot Be Set at a Level That Ignores Shrinkage.**

The scientific work that suggests that a cheddar cheese plant can achieve a recovery of butterfat in cheddar cheese higher than 90 percent bases that conclusion on the theoretical amount of cheese that can be produced in a closed system, starting from a given quantity of milk in the vat in the plant. (Barbano (Cornell), p. 595). But handlers must pay for milk based upon the quantities measured at the farm, not in the vat. Id. And there are significant losses of milk—"shrinkage" --that occur between the time the milk is measured at the farm and the point at which the finished product is produced. (Yonkers (IDFA) , Exh. 14 at p. 36). Dr. Barbano prepared a graphic illustration of the many steps along the way where the handler experiences shrinkage. (Exh. 19).

Expert testimony, based upon data from 51 cheese facilities throughout the country, establish that even when a manufacturer follows best practices, using state of the art equipment, in-plant shrinkage alone is on the order of 2%. (Lenahan (Ecolab), pp.1250-56, 1260-61; Exh. 35). That data was confirmed by cheese company testimony. (E.g., Taylor (Leprino), p. 1729). Under the federal order system, the manufacturer must pay for that milk, including the protein contained in that milk, even though, by definition, none of it makes its way into a finished product, and the manufacturer accordingly gains no economic benefit from it.

This shrinkage is not accounted for in the make allowance, or anywhere else in the product pricing formula. The only place where shrinkage can be accounted for under the current formula is in the yield factor. (Barbano (Cornell) , pp. 595-97). Setting a yield factor below that which is theoretically achievable in a closed system starting with the milk in the vat is precisely how that should be accomplished. That is what the current product price formula does. Raising the yield factor in the direction of the theoretical yield is a step in the wrong direction. (Yonkers (IDFA) , Exh. 14 at p. 39).

**2. Class III Is Not Limited to Cheddar Cheese Produced at a Single Butterfat Recovery Rate.** Another reason why the yield should not be changed relates to the fact that the Class III price is the minimum price that must be paid for all hard cheeses, and not just cheddar cheese. Indeed, only 35% of the cheese manufactured in the United States during 1999 was cheddar cheese. In addition, there is not data available which indicates the average butterfat recovery rate of the cheddar cheese transactions reported in the NASS Dairy Products Prices report. Using the wrong yield

factor, even with the correct price series, could overstate the total value of cheese from a given unit of milk. (Yonkers (IDFA) , Exh. 14 at p. 37).

Any formula that overstates the amount of dairy products that can be produced from a unit of milk components overstates the wholesale sales value attributed to the yield of each component. Thus, a yield factor that is based upon cheddar cheese, but applies to lower yield cheese as well, will overprice the milk going into those cheeses.

This phenomenon was recognized by USDA in the final rule, and in fact formed the basis of its decision to reject proposals to set the yield factor in the formula at .91 rather than .90:

“Since Class III includes other types of cheese, such as mozzarella that has a lower fat retention than cheddar cheese, increasing the value attributed to that retention is not appropriate. Increasing the protein price for all milk used in Class III based on only a portion of the products included in Class III would put other Class III products at a competitive disadvantage. Calculation of a *minimum price* (emphasis added) will enable handlers to adjust prices paid to producers above the minimum federal order prices. Therefore, the 1.582 factor will be used in the protein price formula contained in this decision.” Federal Register, Volume 64, page 16099.

(Yonkers (IDFA) , Exh. 14 at pp. 37-38).

Some witnesses suggested a need to adjust the current formula because they believed that it assumed that the percentage of casein in crude protein was .75 when it should be .78. But the people who first devised that formula exhaustively demonstrated that it already assumes that the percentage is .78. (Brown (National All Jersey), pp. 1660-64, Exh. 49). Accordingly, no change is needed.

**A. Non-Fat Solids.**

Currently, the federal order product price formula for nonfat solids used to calculate the Class IV price includes a divisor of 1.02. Two proposals suggest changes to that divisor (Proposal Nos. 27 and 28). One proposes changing the divider to .99,

and the other to .975. Both proposals are based on the purported need to account in the divider for the average percent moisture in nonfat dry milk (assumed to be 2 percent moisture in Proposal No. 27 and 2.5 percent moisture in Proposal No. 28).

These proposals might make sense if the only thing produced when raw milk is processed into Class IV products were butter and nonfat dry milk. But in fact, raw milk processed into Class IV dairy products (butter and nonfat dry milk) will also yield some nonfat solids in the form of dry buttermilk, a lower valued product. (Yonkers (IDFA) , Exh. 14 at p. 39).

Indeed, the key reason USDA noted in the final rule for selecting the 1.02 yield factor for nonfat dry milk was the need to account for this dry buttermilk:

“Since buttermilk powder is also a product of manufacturing butter and nonfat dry milk, its value needs to be addressed. Because the proposed rule did not account for the yield of buttermilk, the .96 factor was appropriate. However, failing to account for buttermilk powder resulted in overstating the nonfat solids price since the pounds of nonfat solids were understated. Use of the 1.02 factor allows the nonfat solids contained in nonfat dry milk and buttermilk powder to be accounted for, and the value of all nonfat solids to be accurately reflected in the nonfat solids price.” Federal Register, Volume 46, page 16098.

IDFA agrees with that analysis. USDA made the correct adjustments in setting a yield factor of 1.02, in order to account for the fact that nonfat solids in dry buttermilk are a product of Class IV processing, and have a lower value than those used in nonfat dry milk. This is evident in the fact that, over the 19-month period beginning September 1998, the Central states dry buttermilk average \$0.798 per pound, while the Central states (mostly) price for nonfat dry milk averaged \$1.043 per pound, a difference of 24.5 cents per pound. (Yonkers (IDFA) , Exh. 14 at p. 40).

The adoption of a yield factor in the final rule of 1.02 accounts for this lower value of dry buttermilk without unduly complicating the nonfat solids product price formula.

The only other manner in which this could be accomplished would be to add a dry buttermilk component to the federal order product price formulas. But this would require that dry buttermilk be added to the NASS dairy products prices survey, and that a make allowance and yield factor be established for this product. This would be a quite burdensome undertaking, for very little benefit. It is a far better solution to account for dry buttermilk through the adoption of the 1.02 yield factor, as the final rule has done. The testimony of Bob Wellington (Agrimark), pp. 1497-1502, provided a more than ample technical justification for using a yield factor of 1.02 -- or even higher -- once one accounts for the impact of dry buttermilk. Therefore, IDFA opposes Proposal Nos. 27 and 28, which would abandon this approach without providing any alternate means of addressing the dry buttermilk issue. (Yonkers (IDFA) , Exh. 14 at pp. 40-41).

**V. FINISHED PRODUCT PRICES SHOULD CONTINUE TO BE DETERMINED THROUGH THE NASS SURVEYS.**

The product price formulas used to determine minimum milk prices under the final rule are based on the wholesale selling prices of butter, cheddar cheese, non-fat dry milk and dry whey. As a primary building block of federal order minimum milk prices, these wholesale prices determine what handlers pay and producers receive for all milk regulated under the federal order program. Therefore it is imperative that the wholesale selling prices used to determine minimum federal order producer prices represent the wholesale value of the underlying product in the marketplace as accurately and completely as possible. Accurately representing the average wholesale price of these products in the marketplace can only be accomplished by including the largest possible sampling of wholesale prices. (Yonkers (IDFA) , Exh. 14 at p. 41).

For that reason, the product prices used to determine federal order minimum prices must represent actual market sales transactions. In addition, the product price data should represent transactions from all areas of the country, and not be limited geographically to one sales region or one region. Finally, such price data should include the largest volume of manufactured dairy products as possible. (Yonkers (IDFA) , Exh. 14 at p. 41).

Currently, only the dairy product prices survey conducted weekly by the National Agricultural Statistics Service of USDA meets these criteria. IDFA supports its continued use, and opposes all proposals to substitute a different information source. IDFA therefore opposes Proposals 1, 10, 19, 26, and 27. (Yonkers (IDFA) , Exh. 14 at pp. 41-42). Nearly all of the hearing participants supported this position , including Coughlin (NMPF) p. 197.

A few parties supported using the Chicago Mercantile Exchange (CME) spot markets instead of the NASS survey prices. But only three cooperatives joined in that position, none of whom own any cheese, butter or nonfat dry milk facilities, and their membership totaled less than 50 farmers. (VandenHeuvel, pp. 952-56).

USDA in the final rule discussed the many reasons why the CME is not a suitable data source for any of the four products at issue. First, noting that the CME weekly cash butter contract had been used in setting the butterfat differential, the final rule states "This price series has been criticized due to the 'thinness of trading.'" With respect to cheese, USDA stated in the final rule "Criticism of the cheese exchange trading, including inaccurate representation of cheese prices and accusations of market manipulation, reached the point that the National Cheese Exchange (NCE) discontinued

trading, and cash trading of cheese moved to the CME. The CME also has received some criticism for thinness of trading.” While there exists a cash contract for nonfat dry milk at the CME, USDA noted in the final rule that “There is very limited exchange trading of nonfat dry milk.” Finally, there is no cash exchange market for dry whey. (Yonkers (IDFA) , Exh. 14 at p. 42).

All of the available evidence supports the correctness, both then and now, of USDA's decision in the final rule not to utilize CME data. Since September 1998, the volume of cheddar cheese included in the NASS dairy products prices survey has represented 26.4 percent of all cheddar cheese production in the U.S. During the same 18-month period through February 2000, the CME volume of cheddar cheese traded represented only 1.7% of U.S. cheddar cheese production. To switch from the NASS data to the CME data would be to switch from a very broad, to an extremely thin, representation of actual cheese transactions. (Yonkers (IDFA) , Exh. 14 at pp. 42-43).

The same is true for butter. For the same 18-month period, the NASS survey volumes represented 14.4 percent of all U.S. butter production, while CME trading volumes consisted of only 2.6%. (Yonkers (IDFA) , Exh. 14 at p. 43).

This thinness carries two consequences. First, it raises the very real prospect that the reported prices are not, in fact, representative of finished product transaction prices. But the prices used to set minimum milk prices must be accurate if the entire pricing system is to function properly. Second, these markets are sufficiently thin so as to encourage purchasing for the purpose of causing minimum milk prices to rise, if they formed the basis of minimum milk prices. (Yonkers (IDFA) , Exh. 14 at p. 43).



In addition to their thinness, the CME market is not national in scope. In the final rule, USDA noted that "the scope of the surveys that have been undertaken by NASS, and their geographic representation, appears to be comprehensive." But because the CME spot prices represent transactions in Chicago only, the CME spot prices do not satisfactorily capture the national scope of manufactured dairy product markets. (Yonkers (IDFA) , Exh. 14 at p. 43).

A final criticism of using CME spot prices in determining federal order minimum prices concerns the impact on futures markets. The Commodity Futures Trading Commission (CFTC) has strict rules to protect against manipulation of underlying cash markets for the purpose of reaping large gains on futures positions. For example, in the thinly traded CME spot cheese market, it would be possible for a cheese manufacturer to take a large short futures position by selling several (200) milk futures contracts and then sell a small quantity of cheese (10 carloads) on the CME spot market well under the opening cash price. If there is not adequate trading for the spot cheese market to rebound in the same trading session and the cheese manufacturer is able to move the spot market dramatically lower by selling a small quantity of cheese on the spot market the milk futures market will respond by dropping accordingly. The cheese manufacturer then buys back the 200 futures contracts at the reduced futures price and makes \$10 profit in the futures markets for each dollar lost in the spot market. (Yonkers (IDFA) , Exh. 14 at p. 43-44).

To protect against this type of manipulation, the CFTC determines futures position limits based on the volume represented by the underlying cash market. In the case of the milk futures market, the underlying reference prices are the NASS survey

prices (cheese, butter and dry whey) used to determine the Class III milk price. (Yonkers (IDFA) , Exh. 14 at p. 44).

Because the NASS survey captures 15-25% of the market for these products it would be very difficult for one manufacturer to manipulate the survey prices, therefore, the CFTC allows rather liberal position limits on the milk futures contracts. This encourages trading activity which increases liquidity in the market and allows adequate opportunities for hedgers to secure price protection.

However, adopting the much thinner traded CME spot market as the basis for determining Class III prices would dramatically increase the opportunity to manipulate the cash market for futures market gains. Consequently, the CFTC likely would have to dramatically reduce futures market position limits for contracts based on either class milk prices or dairy product prices. This would provide a disincentive to traders to participate in the futures markets and thereby reduce producers and processors' ability to gain price protection by hedging their sales or purchases on the futures markets. (Yonkers (IDFA) , Exh. 14 at pp. 44-45).

## **VI. THE NASS SURVEYS SHOULD BE IMPROVED.**

For these reasons, the federal orders' reliance upon the NASS Surveys should be retained. But the surveys should be improved, in two ways.

### **A. The NASS Surveys Should Include 640-pound blocks.**

As set forth in Proposal No. 12, the NASS cheese survey should be expanded to include 640-lb blocks. While no publicly available data on total production of 640-lb block cheddar cheese production exists, industry estimates suggest that 640-lb blocks represent as much as 27 percent of total cheddar cheese production. Reinke (Kraft) p. 1043. This was supported by Eastham (Great Lakes Cheese) p. 1279, who stated that

640-lb blocks are playing an ever-increasing role in the cheese market, and Gulden (AMPI) p. 1187, who stated that AMPI has 7 cheddar cheese plants, and 80 to 85 percent of this cooperative's cheddar cheese production at its manufacturing plants is in the form of 640-lb barrels.

Intentionally excluding such a large percentage of cheddar production dramatically limits the NASS survey's ability to represent the true wholesale value of cheddar cheese. (Yonkers (IDFA) , Exh. 14 at p. 45).

Under no circumstance should any proposal be accepted that would reduce the percentage of cheese covered by the NASS survey which is included in the product price formulas. IDFA strongly opposes Proposal No. 1, which in addition to proposing to use the CME instead of the NASS survey, also proposes to use only cheddar cheese data for 40-lb block packages. Over the period September 1998 through February 2000 the combined 40-lb block and 500-lb barrel volume of the NASS survey represented 26.3% of total cheddar cheese production, with 500-lb barrels representing 61% of the NASS survey volume. Eliminating 500-lb barrel cheese in calculating federal order minimum prices would have reduced the sample (26.3% of total cheddar production) to only 9.5%. (Yonkers (IDFA) , Exh. 14 at pp. 45-46).

**B. Greater Steps Should Be Taken to Verify the NASS Survey Data.**

While IDFA strongly supports the continued use of the NASS surveys, they can be improved. Unlike all other agricultural commodity data collected by USDA, this is the only data used directly to determine minimum prices that must be paid to producers by processors. The current NASS survey is neither mandatory nor subject to audit or verification in any way.

IDFA urges USDA to make changes to the NASS dairy products prices survey in order to minimize potential errors that could result in mis-specification of minimum prices. One option would be to make the NASS survey mandatory. (Yonkers (IDFA), Exh. 14 at p. 46 and the Appendix thereto).

At the very least, the NASS survey should be modified in order to allow USDA to periodically ascertain whether or not wholesale sales transaction data is being reported correctly. One way to do so, which is fully supported by IDFA, is to verify periodically that the data reported by manufacturing plants is confirmed by those customers purchasing the products. We recognize that actual cheese manufacturer audits of bulk cheese sales would be an additional regulatory burden, both on the part of USDA and the cheese manufacturers. Therefore, IDFA proposes the following procedure for bulk cheese price verification. First, modify the existing transaction survey form to include reporting by each cheese manufacturer of their largest three or four buying firms that week. USDA could then select a small sample of survey respondents each week and contact the indicated bulk cheese buyers regarding confirmation of such a purchase, and the average price paid to that cheese manufacturer. This verification process minimizes the reporting burden on any party to the bulk cheese transaction. IDFA considers this verification process necessary for all dairy product prices used to calculate minimum prices for milk under federal milk marketing orders. (Yonkers (IDFA), Exh. 14 at pp. 46-47).

**VII. THE ADJUSTMENT TO THE NASS SURVEY PRICE OF CHEDDAR CHEESE IN 500-LB BARRELS AND 640-LB BLOCKS SHOULD BE REDUCED FROM 3 CENTS PER POUND OF CHEESE TO 1 CENT PER POUND OF CHEESE**

Under current federal order pricing, the NASS dairy products prices survey price for cheddar cheese sold in 500-lb barrels has a price adjustment. During the informal

rulemaking process leading to the final rule, it appears that this was entirely based on the historical difference between the wholesale price cheddar cheese sold in 40-lb blocks and the moisture-adjusted (to 39% moisture) wholesale price for cheddar cheese sold in 500-lb barrels. This 3-cents per pound of cheese has often been cited as representing the difference in the costs of manufacturing and, especially, packaging cheddar cheese in these two package sizes. (Yonkers (IDFA) , Exh. 14 at p. 47).

However, this 3-cents really consists of two components. The first relates to the actual differences in costs of manufacturing between 40-lb blocks and 500-lb barrels. (Yonkers (IDFA) pp. 308-10; Reinke (Kraft) pp. 1044-46; and Taylor (Leprino) pp.1723-27). The second relates to the fact that, in the market, the price received for cheddar cheese in 500-lb barrels is adjusted to 39% moisture, while the actual percent moisture for cheddar cheese in 40-lb blocks is about 38%. (Barbano (Cornell) pp. 616-18). Therefore, this part of the 3-cents is only due to the difference in the moisture content of cheese in the two sizes.

Since yield formulas for cheddar cheese are based on the percent moisture in the cheese, milk with the same level of components will result in a different yield of cheese at different moisture levels in the cheese. For example, cheddar cheese in 500-lb barrels is frequently reported to average about 35% moisture in the NASS Dairy Products Prices survey, while cheddar cheese in 40-lb blocks is usually found to have about 38% moisture. An equivalent volume of farm milk with the same component levels will therefore result in fewer pounds of cheddar cheese made into 500-lb barrels than if that same milk was made into 40-lb block cheddar cheese. This is seen in the following table where, despite receiving a higher moisture-adjusted price per pound of

cheese in the marketplace, the fact that there are fewer pounds to sell from the same volume of farm milk with identical component tests is critical. The result of a 3-cent difference in the price of cheese in 40-lb blocks versus a 39% moisture-adjusted price of cheese in 500-lb barrels is only 9.17 cents per cwt of milk, or only .92 cents (rounded) per pound of 40-lb block yield. The bottom line is that, per pound of 40-lb block yield, a manufacturer of cheddar cheese in 500-lb barrels has only a .92 cents advantage over a manufacturer of 40-lb blocks, not 3 cents per pound. Therefore, the other part of the 3 cents, 2.08 (3 cents minus .92 cents) is due to the moisture only.

<b>CME Block &amp; Barrel Price Analysis</b>			
Assumptions			
Milk Fat	3.67		
Milk Protein	3.18		
Fat Recovery	0.90		
Barrel Moisture	35.0%		
Casein % of Protein	78.0%		
Block Make allowance	\$0.17		
Yield Formula Cheddar	((Milkfat*Fat Recovery)+(CrudeProtein*%Casein in Protein - 0.1))*1.09 / (1 - cheese moisture)		
Barrel Price Formula	Barrel Market * (1 - barrel moisture)/(1 - 0.39 legal max moisture for cheddar)		
	<b>Typical Business</b>		
			<b>Block -</b>
	<b>Block</b>	<b>Barrel</b>	<b>Barrel</b>
Typical Moisture	38.00%	35.00%	
Cheese Yield	9.992	9.531	
Market	\$1.3000	\$1.2700	\$0.0300
Market + moisture for barrel	\$1.3000	\$1.35328	
Gross Return = Yield * Price	\$12.9893	\$12.8976	
	<b>Block vs.</b>	<b>Block vs.</b>	
	<b>Barrel</b>	<b>Barrel</b>	
	<b>\$/cwt</b>	<b>\$/lb</b>	
	<b>\$0.0917</b>	<b>\$0.0092</b>	

(Yonkers (IDFA) , Exh. 14 at pp. 48-49).

In short, the three-cent difference in observed market prices per pound of cheese is actually a difference per pound of dry matter in the cheese of about one-cent.

(Reinke (Kraft), pp. 1044-46; Taylor (Leprino), pp. 1723-27); Yonkers (IDFA) p. 48).

Indeed, there is substantial reason to question whether there is really any difference at all in the cost of manufacturing the two cheeses; Eastham (Great Lakes Cheese), p. 1290 stated that there is little or no difference in the manufacturing cost cheddar cheese between 40-lb blocks and 640-lb barrels.

Accordingly, USDA should reduce the three-cent price adjustment to the 500-lb barrel cheddar cheese price to one-cent, and also use this same one-cent adjustment for 640-lb blocks.

#### **VIII. THE BUTTER PRICE SHOULD BE REDUCED BY SIX CENTS, AND FOR ALL CLASSES.**

USDA historically has used the wholesale grade A butter price in any formulas to determine the minimum price of butterfat used under federal order regulation. This was true when the Chicago Mercantile Exchange's grade A butter market was operating, when this wholesale price was used in the calculation of the butterfat differential. When the CME eliminated the trading of grade A butter, USDA substituted the CME grade AA butter price minus 9 cents, which represented the historical difference between these two grades of butter. (Yonkers (IDFA) , Exh. 14 at p. 50).

Currently, the NASS survey price for butter used in the Final Rule Class III and IV product price formulas for butterfat is based on a survey of only grade AA butter prices. The Final Rule uses this NASS grade AA butter price without any adjustment to represent the difference between grade AA and grade A butter. The resulting higher

value for butterfat under the Final Rule appears to be unintended, as the Final Rule never discusses this matter. (Yonkers (IDFA) , Exh. 14 at p. 50). As a result of this oversight, the present system establishes minimum prices for butterfat that may not be at market clearing values because bulk fluid cream is sold into an unregulated market. (Ledman (Suiza Foods) , p. 1333).

IDFA proposes (Proposal No. 4) that USDA adjust the butter price used in the product price formulas by six cents, to correct the fact that the NASS dairy products prices survey is only of grade AA butter. This would base the value of butter used to determine the minimum price of butterfat on an equivalent to the grade A butter price. (Yonkers (IDFA) , Exh. 14 at p. 50).

This change to the butterfat value should apply to all classes of milk, including Class II. In the final rule, USDA noted that "Butterfat used in Class II products competes on a current-month basis with butterfat used in cheese and butter, and its price should be determined on the basis of the same month's values." This is sound economics. (Yonkers (IDFA) , Exh. 14 at p. 50).

Numerous hearing witnesses presented detailed regarding the market for butterfat, and the competition for the excess butterfat that Class I handlers must dispose of due to the fact that the raw milk they buy has a higher butterfat content than the finished product they sell. A Class I handler regulated by a federal order selling cream is not just concerned with the price received for that cream, but rather the difference between that price and its federal minimum price obligation. (Yates (Suiza Foods) p. 799-802). Class I handlers account to the pool for the excess butterfat that they sell at the class price of the handler to whom they sell it.



Class II, III and IV handlers are all purchasers of that excess butterfat from Class I handlers. Many Class II and III handlers testified regarding the need for such handlers to have the same ability to compete for fat as the Class IV handlers. Blaise (Wells Dairy) pp. 1375-76, Galloway (Galloway) pp. 1426-31, M. Schanback (Friendship Dairies) pp. 1632-34, and Throne (Hershey) pp. 1673-79. As explained by W. Schanback (Friendship Dairy), pp. 1637-41, under current regulations, a Class I handler is indifferent whether it sells its excess butterfat to a Class II, III or IV handler, because the price at which the Class I handler must account to the pool is the same. But if the butterfat value were to be reduced by six cents for Class IV only, then the Class I handler will have a six cent lower obligation to the pool if it sells its excess butterfat to a Class IV handler instead of a Class II or III handler. This would put Class II and III handlers "at a great disadvantage." *Id.* at 1640.

Moreover, a failure to adjust the butterfat price equally for all classes raises the real prospect of an increase in the substitution of lower priced Class IV products for higher class milk. Even under the current final rule provisions, if butter prices rise sufficiently over a short period of time, a strong economic incentive exists to advance purchase butterfat in the form of Class IV products such as butter or anhydrous milkfat. This occurs if butter prices rise more than the cost of converting butterfat to butter (the final rule make allowance suggests this cost is 11.4 cents per lb.) or anhydrous milkfat and then back to a form for use in further manufacturing. Of course, the costs of storing butter or anhydrous milkfat for those few months must also be taken into account. (Yonkers (IDFA) , Exh. 14 at p. 51). Numerous witnesses-- Blaise (Wells Dairy), pp. 1375-76; Galloway (Galloway), pp. 1426-31; M. Schanback (Friendship Dairies), pp.

1632-34; Throne (Hershey) pp. 1673-79 -- all testified to the fact that their companies all regularly look at the cost of alternative sources of butterfat such as anhydrous milkfat.

Adopting the 6-cent reduction in butterfat prices in Class IV only (suggested in Proposal Nos. 8) would provide significant added incentive to advance purchase Class IV butterfat products and store them. Furthermore, the incentive to substitute would be just as strong for Class III manufacturers as for Class II handlers if the six cent reduction only applied to Class IV. Cheese manufacturers can use butter in making cheese, and they would have the same incentive as a Class II handler to advance purchase butterfat as a Class IV product rather than buying butterfat in producer milk. (Yonkers (IDFA) , Exh. 14 at p. 51).

In short, adopting a proposal that changes the relative prices of butterfat in Class II and IV, effectively increases the Class II differential on butterfat from 0.7 cents to 6.7 cents, would clearly increase the frequency of substitution of Class IV butterfat products for producer milk, the type of disorderly marketing conditions that the federal order system was designed to eliminate. (Yonkers (IDFA) , Exh. 14 at p. 51).

Proponents of a change for only Class IV butterfat did not succeed in presenting a compelling case for such a change. The data presented by Schad (Land O'Lakes), pp. 1201-02, on the added costs of using cream in other dairy products clearly applied to cream used in all classes of milk, and by his own calculations only applied to at most 65.8% of the butterfat used to make Class IV products. In fact, Schad stated that users of cream in all classes of milk face the same costs (p. 1221). Agrimark only makes 60% of its butter from cream, a figure expected to fall to 50%. (Wellington

(Agrimark), pp. 1491-92). Similar testimony was received from Hollon (DFA), p. 1544. IDFA considers this to be in support of including these costs in the make allowance used in the butter product price formula. However, it is interesting to note that while both Land O'Lakes and DFA testified to the fact that these costs are not currently accounted for in the federal order butter product price formula, both supported reducing the make allowance used in that formula. These positions are at best inconsistent, and appear to be focused on the goal of reducing a key ingredient cost for the butter manufacturing operations of the two cooperative associations relative to other uses of butterfat in the marketplace.

**IX. ANY INCREASE IN THE CLASS IV SKIM MILK PRICE SHOULD BE REFLECTED IN AN EQUAL AND OPPOSITE DECREASE IN THE 70-CENT DIFFERENTIAL.**

Several proposals would have the effect of increasing the Class IV skim milk price (Proposal Nos. 27 and 28). IDFA has already explained why these proposals should not be adopted. But if any are adopted, then USDA needs to also reduce the Class II differential by an equal and opposite amount.

In the final rule, USDA noted that "Generally, the source of inputs alternative to producer milk for the manufacture of Class II products is dry milk products and butterfat that otherwise would be used in butter. Basing the price of milk used to make Class II products on these alternative ingredients should help considerably to remedy a situation in which it is perceived that a separate product class for dry milk (Class III-A) has resulted in a competitive advantage over producer milk used to produce Class II products. The 70-cent differential between the Class IV and Class II skim milk prices is an estimate of the cost of drying condensed milk and re-wetting the solids to be used in Class II products."

This analysis is basically sound (leaving aside for today whether 70 cents is the right number), but it is more accurate to state that the price relationship on which to focus is not that between the Class IV and Class II skim milk prices, but rather that between the wholesale price of nonfat dry milk and the Class II skim milk price. It is the relationship between those two prices that determines whether a processor has an economic incentive to switch from using Class II skim milk to Class IV nonfat dry milk. When a processor does so, farmers are the losers, because they lose the right to obtain the higher price that Class II milk obtains. (Yonkers (IDFA) , Exh. 14 at p. 53).

Some of the proposals would raise the Class IV skim price. But for the reasons outlined in Section I-A, any changes resulting from this hearing in the Class IV skim milk price will have no direct effect on the wholesale price of nonfat dry milk. However, any increase in the Class IV skim price would increase the Class II skim price by the same amount, given that the Class II skim price is the Class IV skim price plus 70 cents. (Yonkers (IDFA) , Exh. 14 at pp. 53-54).

In the final rule, USDA determined that the correct relationship between the wholesale value of nonfat dry milk and the Class II skim milk price should be 70 cents per equivalent units. If that relationship is to be maintained, then any increase in the Class IV skim milk price (and the resultant increase in the Class II skim milk price) must be offset by an equal and opposite decrease in the 70-cent Class II differential. Without such an adjustment, the difference in value between the wholesale sales value of nonfat dry milk and of the Class II skim milk price would increase, resulting in an increase in the incidence of using alternative Class IV ingredients as a substitute for skim milk in Class II products. (Yonkers (IDFA) , Exh. 14 at p. 54).

**X. USDA SHOULD GIVE SERIOUS CONSIDERATION TO USING AN AVERAGING OF CLASS III AND IV PRICES FOR PURPOSES OF SETTING THE CLASS I PRICE.**

The Family Dairies USA and Midwest Dairy Coalition proposal to use a weighted average of the Class III and IV prices to set the Class I price (Gran and Cropp, pp. 1439-74) warrants serious consideration by USDA. IDFA agrees with the observation of these proponents that the current use of the higher of these two prices has had unintended consequences, with the price of forty percent of milk (i.e., that used for Class I) being determined in many months by the price of ten percent of milk (i.e., Class IV milk). For the reasons explained in their testimony, this results in a price signal to farmers that may be precisely the opposite of what overall market conditions would dictate.

**XI. USDA SHOULD ISSUE A RECOMMENDED DECISION.**

USDA's normal practice is to issue a recommended decision, and receive written comments, before issuing a final decision. That procedure should be followed here.

A recommended decision can be omitted only if the record evidence demonstrates that "due and timely execution of [the Secretary's] functions imperatively and unavoidably require such omission." 7 C.F.R. § 900.12(d); 5 U.S.C. § 557(b)(2). These conditions do not exist here. The milk industry does not face any emergency situations. The final rule, although subject to improvements, is functioning appropriately. The prerequisites to the omission of a recommended decision are not present. Furthermore, while Congress has required that any changes resulting from these hearings be published by December 1, 2000, and implemented by January 1,

2001, there should still be ample time for the Department to issue a recommended decision first.

A recommended decision is particularly desirable in light of the recent experience in the informal rulemaking that lead to the final rule. The ability of interested persons to provide written comments on the proposed rule provided an opportunity to point out some significant shortcomings in the regulatory provisions under consideration, and in many cases lead to significant improvements in the final rule as adopted by USDA. The same opportunity should be afforded here.

Respectfully submitted,



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CERTIFICATE OF SERVICE

I certify that I have served the foregoing Post Hearing Brief of the International Dairy Foods Association by U.S. Mail by postage prepaid this 14<sup>th</sup> day of July, 2000 on the following individuals:

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A handwritten signature in black ink, appearing to read "S. J. Rosenbaum", written over a horizontal line.

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