

**Before the United States Department of
Agriculture
Agricultural Marketing Service**

In the Matter of Proposed Amendments :	:	Docket Number
to Tentative Marketing Agreements :	:	AO-14-A74, et al.
and Orders :	:	DA-06-01

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

January 24, 2006

Exhibit _____

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

Land O'Lakes (LOL) is a dairy cooperative with over 4,000 dairy farmer member-owners. The cooperative has a national membership base, whose members are pooled on six different Federal orders. Land O'Lakes owns numerous cheese plants and a butter/powder plant. These plants are regulated under the Federal orders.

I testify today in support of Agri-Mark's proposal to update the manufacturing cost indices used to determine butter, nonfat dry milk powder, cheese and dry whey powder.

Background of Determining Class Prices

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

Determining the class prices starts with the NASS price series, which describes commodity-specific products, cheddar cheese in 40 pound blocks and 500 pound barrels; butter in 25 kilogram and 68 pound boxes and NFD and whey in "bag, tote or tanker sales." NASS reports the total price received at plants for the commodities. During the last few years, DairyAmerica, a NFD selling marketing agency-in-common, increased its selling price of NFD in recognition to increased energy costs. Naively, DairyAmerica believed that a line item energy surcharge would not be captured in the NASS survey and the surcharge could be passed back to the

manufacturing plant. In actual practice, NASS captured the DairyAmerica energy surcharge in its reporting of the selling price of NFDM.

The manufacturing allowance is fixed; any increases to the selling price to capture increased costs are reported to NASS and all dairy farmers, regardless of whether their marketing organization incurred the costs, benefit from the higher class prices.

The second step of the process is to determine the cost of converting milk to the commodity whose price is quoted in the NASS survey. The Department is scrupulous in making sure that commodity manufacturing costs are tied to the product described by the NASS survey. For instance, in the Federal Order Reform process and the Final Rule from the 2000 Hearing, USDA subtracted the butter packaging cost from the RCBS survey and substituted the CDFFA butter packaging costs. The reason for the substitution was that the CDFFA costs better reflected the costs of bulk butter, while the RCBS cost represented the costs of packaging print butter. The NASS butter price reports the market selling price of bulk butter.

The residual of this calculation is the Class III or IV price. The price is designed to be the minimum regulated class price for the commodity. Additionally, USDA defines the Class IV price to be the market clearing price and explicitly adds a component for balancing costs in the make allowance for Class III and IV.

Background of the Current Make Allowance Calculation

The Federal Order Reform and 2000 Class III and IV final decisions set forth a process to determine make allowances. USDA averaged the costs of cooperatively-owned manufacturing plants with the costs reported by the plants regulated by the California Department of Food and Agriculture (CDFFA). The costs at the cooperatively-owned plants are reported by the Rural Cooperative Business Service of USDA (RCBS). Manufacturing costs were presented at the 2000 Hearing by other interested parties, however, USDA found them lacking in specificity or design.

For the Final Decision of the 2000 Hearing USDA combined the weighted average of all California cheese plants with the RCBS weighted average to set the make allowance for cheese to be used in the Federal orders. For NFDM, the weighted average of the two lower cost subgroups of the CDFFA

survey were combined to set the NFDN make allowance to be used in the Federal orders. For butter, USDA combined the highest cost subgroup of California butter plants with the RCBS weighted average to set the butter make allowance. For whey, USDA adopted a make allowance of \$0.159, reflecting a higher drying cost compared to NFDN and the NCI reported cost.

USDA recognized that the RCBS survey did not include all relevant manufacturing costs. To approximate the costs associated with return on investment and general and administrative costs, USDA added to the RCBS costs the reported ROI or G&A costs from the appropriate CDFA group or subgroup. Additionally USDA added a \$0.0015 cost per pound to the RCBS and CDFA costs as an estimate of marketing costs.

Charles Ling, RCBS, has testified earlier relating to the inadvertent error contained in the calculation of the make allowances from the 2000 Hearing. The RCBS Survey from 2000 that was presented to that Hearing included two butter and two NFDN plants that were located in California. The 2000 Manufacturing Cost Annual, published by CDFA, stated that 99.5 percent of the butter and 98.9 percent of the NFDN produced in California was manufactured by the plants included in the survey. Obviously these two California butter and powder plants were included in both the RCBS and CDFA surveys.

Page A of LOL Exhibit ___ is the 1998 Dairy Product Plant Costs, as reported by RCBS at the 2000 Hearing.

Page B of LOL Exhibit ___ is the 1998 Dairy Product Plant Costs, as revised by RCBS. This report excludes the California Butter and Powder Plants.

Page C of LOL Exhibit ___ is the Calculation of the Butter Make Allowance, using the data from Page A.

Page D of LOL Exhibit ___ is the Calculation of the Butter Make Allowance, using the data from Page B.

Page E of LOL Exhibit ___ is the Calculation of the NFDN Make Allowance, using the data from Page A.

Page F of LOL Exhibit ___ is the Calculation of the NFDN Make Allowance, using the data from Page B.

Page G of LOL Exhibit ___ is the Calculation of the NFDN Make Allowance, using the data from Page B and with an alternative CDFA weighting.

When the California plants are excluded from the RCBS survey, the resulting make allowance calculation increases. Had the RCBS evidence in the 2000 Hearing been correct, it is arguable that the current butter make allowance would be \$0.1195 (LOL Exhibit __, Page D), instead of the current \$0.115 per pound, and the NFDM make allowance might be \$0.1422 (LOL Exhibit __. Page F), instead of the current \$0.14 per pound.

Additionally, had this evidence been available to USDA at the 2000 Hearing, the Department might have decided to weigh the California information differently. The Final Decision states:

The basis for using the two lower-cost groups of California plants is that the mid-cost group is of a similar average size as the group included in the RCBS survey, and that the lowest-cost California group has a very similar total cost to the mid-size group. (Federal Register/Vol. 67, No. 216, November 7, 2002, page 67,921).

Given this revised evidence, the Department may have concluded that the average RCBS plant size of 29.1 million pounds was not as comparable to the average Group II CDFA powder plant; and that the new RCBS cost of \$0.1711 per pound might have resulted in a different weighting selection. LOL Exhibit __, page G shows the make allowance calculation had the Department chose to weigh the RCBS costs with the Weighted Average of all the CDFA powder plants. Such a calculation would have set the current NFDM make allowance at \$0.1451 instead of the current \$0.14 per pound.

USDA Should Include Balancing Costs in the Make Allowances

In the Final Decision regarding market service payments in the Northeast Order for balancing costs, USDA has made it clear that the Class III and IV make allowances include recognition for the costs of balancing. To that point the Secretary stated:

The Class III/IV Final Decision that adopted product price formulas for all Federal milk marketing orders, including the Northeast order, gave specific recognition to the costs associated with balancing in the make allowance factor in setting the Class III and Class IV milk price. ADCNE's exception is not persuasive. As already stated, the Class III/IV pricing formulae include a factor to offset the cost of balancing

performed by butter-powder plants. (Federal Register/Vol. 70, No. 19, January 31, 2005, page 4,953).

The costs of balancing the market are real. At the Federal Order 1 Market Service Hearing, Land O'Lakes submitted testimony regarding plant utilization at its Carlisle facility (LOL Exhibit __, Page K). That table illustrates the function of a balancing plant to the market. In August 2001 the Carlisle plant had deliveries of total milk solids at 50 percent of capacity and only nine months later in May 2002, the plant received total milk solids at 100 percent of its capacity. As stark as this comparison is, monthly data actually mask the daily and weekly balancing demands.

Fixed costs on a per unit basis at a balancing plant are high. They are built to handle the demands of the highest days' balancing and rarely are they filled to that level for a sustained period. In most businesses labor is considered a variable expense. The firm can add or lay off workers as the work load changes. Labor at a balancing plant is treated as a fixed cost. The employees are highly trained and mobile. Reducing the work force to accommodate fluctuating milk receipts, opens the balancing plant to the risk of being under staffed at a critical time.

The Secretary acknowledged the balancing function within the butter make allowance when he opted for a weighting calculation that resulted in a FMO make allowance greater than the RCBS adjusted weighted average cost. However, the NFDM weighting choice resulted in a \$0.14 FMO make allowance when the RCBS adjusted weighted average cost was \$0.1530 per pound. In lieu of its stated recognition of the costs borne by some to balance the markets, the Secretary might have made a different weighting decision for NFDM in 2000 had the Department known the real weighted average RCBS cost was \$0.1711 per pound.

Land O'Lakes Supports the Agri-Mark Proposal

Land O'Lakes owns and operates many dairy plants within the United States. Among them are two that are included the RCBS survey. They are the butter/powder plant in Carlisle PA and the cheese/whey plant in Kiel WI. Both plants were also included in the RCBS Survey presented at the 2000 Hearing. The costs supplied to RCBS were costs related specifically to manufacturing the commodity product that is contained in the NASS surveys. As all know, Land O'Lakes markets value added, branded cheese

and butter products. Except for butter packaging costs (which was adjusted by USDA in 2000), specific efforts were made to exclude any costs from the RCBS survey, related to the marketing of our branded products.

In 2003 Land O'Lakes chose to finance a portion of its business through the sale of bonds. As these bonds are currently traded on the open market, Land O'Lakes is subject to regulations promulgated by the Securities and Exchange Commission regarding insider trading. Simply put, Land O'Lakes can make no material statement regarding its operations unless the cooperative makes this information available to the general public. For that reason, I must be somewhat circumspect regarding specific information about our operations. Land O'Lakes participated in the RCBS surveys, an aggregating process which allowed for our anonymity. With that said, I can make some general statements about our various operations.

On a unit cost basis, Land O'Lakes' costs at its Carlisle butter plant are up dramatically compared to the 1999 costs. While our butter plant capacity utilization has increased, the per unit cost against almost all categories increased over the five year period.

The same is true at the Carlisle powder plant. Against virtually all categories, the unit costs were greater in 2004 compared to 1999. While total pounds produced were greater in 2004, the percentage of plant capacity declined in 2004 compared to 1999. This is due to the plant expansion at Carlisle during 2000.

The per unit costs at our cheese plant at Kiel increased only marginally compared to 1998. There are two obvious reasons for this per unit achievement in an environment of increasing costs. First, Kiel is an old plant with lower than average depreciation expenses and secondly Kiel experienced a large increase in volume through the plant during the period. Increased volumes and minimal plant investment drove the unit cost equation at the plant.

RCBS did not report whey costs in 2000, so there can be no comparison with the current reported RCBS whey drying costs. Land O'Lakes' cost of drying whey in 2004 is less than the average cost reported by RCBS. While our costs are fairly presented, we do not think them representative of the industry norms. The whey drying operation at Kiel dries the whey produced at the Land O'Lakes cheese plants in Kiel, Denmark and Greenwood WI.

Denmark and Greenwood ship their condensed whey to Denmark for drying, which allows Kiel to run at almost 100 percent capacity. The cost of the evaporation activity at Kiel was determined and that cost was used as the proxy for evaporating costs at Denmark and Greenwood. We have not had the time to test the validity of that assumption. Nevertheless, the per unit efficiency of the whey drying activity at Kiel is dependent on the three-plant system that has evolved in that area and we believe is not representative of industry norms.

Recommendations for CDFA and RCBS Weighting

Land O'Lakes supports the recommendations of AgriMark relating to the weighting of the various groups and subgroups of the CDFA survey with the RCBS survey. In the Final Decision USDA used the criteria of relative plant size, comparable per unit costs and a recognition of balancing costs as criteria for choosing the appropriate California group or subgroup to combine with the RCBS survey in a weighted average calculation. While it may be expeditious to use the same group, subgroup weighting as used in 2000, Land O'Lakes recommends that USDA apply its 2000 criteria to the 2004 realities. One reason for this recommendation is the fact that the RCBS evidence from the 2000 hearing was in error, and had the Department had the correct RCBS information; it may have weighted the cost data differently.

Butter: Land O'Lakes recommends that USDA combine the RCBS weighted average butter cost with the California weighted average cost for all butter manufacturers (LOL Exhibit __, Page H). The average RCBS plant produced 36-million pounds in 2004, while the average California plant ran 48-million pounds. Adjusting for packaging and applying the California ROI and G&A costs plus the marketing expense of \$.0015 per pound, the adjusted RCBS cost was \$0.1714 and the California cost adjusted for marketing expense was \$0.1383 per pound. The weighted average of the two groups was \$0.1515 per pound. Land O'Lakes recommends that USDA weight these two groups because the average plant size is comparable. Additionally, the result of the weighted average is very close to the current California make allowance for butter.

Non-Fat Dry Milk: Land O'Lakes recommends that USDA combine the RCBS weighted average NFDMM cost with Group II of the CDFA powder survey (LOL Exhibit __, Page I). The average production of the RCBS

group, 31-million pounds is closer to any of the subgroups of the CDFA survey (Group II is 59-million pounds). Adjusted for ROI, G&A and marketing expense the RCBS weighted average cost is \$0.1932, while the CDFA Group II adjusted average cost is \$0.1748. The current California make allowance for NFDN is more than a half cent below the most recent weighted average cost and two cents below the Group II average cost. Of all the commodities in question at this hearing, NFDN plays the strongest role in clearing the market of excess milk. Powder plants balance the markets and NFDN is characteristically the first product offered to the CCC. For these reasons, Land O'Lakes recommends that USDA use the CDFA Group II NFDN series as the weighting factor, which would provide a make allowance of \$0.1867 per pound.

Cheese: For this hearing RCBS offered two cheese groups, an "all cheese group and a 40-pound block group. The CDFA cheese survey reports plant costs for 40-pound blocks. In the CDFA survey, the three plants that processed 500-pound barrels or 640-blocks had packaging and packaging labor costs for 40-pound blocks substituted for the reported costs. (California Manufacturing Cost Annual 2004, CDFA, Table 1, Sections 4 and 5, page 8.) For that reason, Land O'Lakes believes the relevant comparison for cheese is the RCBS 40-Pound Block Survey and the CDFA weighted average cheese survey (LOL Exhibit __, Page J). While the Group II cheese plants were closer to the RCBS average production, the cost per pound between the two groups were too great for comparison purposes. The adjusted RCBS cost was \$0.1814 and the adjusted unit cost for the weighted average CDFA was \$0.1784. The weighted average of the two is \$0.1794, which correlates well with the current California cheese make allowance of \$0.1710 per pound.

Whey: The Final Decision used the NCI whey cost data to determine the current make allowance for whey. At the hearing there was persuasive testimony that the cost of whey drying is greater than the cost of drying NFDN. This is the first time RCBS has released a survey of whey drying costs. The weighted average cost of drying whey, as reported by RCBS, is \$0.1155, while CDFA reports a cost of \$0.2673 per pound. The average RCBS plant produces about 10-million pounds per year while the average California plant produces about 31-million. These data is counter-intuitive. Land O'Lakes recommends that USDA consider setting the whey make allowance based on a value above the NFDN make allowance. We are

informed that others will provide data relating to the incremental cost of drying whey, compared to NFDM.

Summary and Conclusions

Land O'Lakes recommends that the Department increase the butter make allowance by \$0.0365 per pound, NFDM by \$0.0467 per pound and cheese by \$0.0144 per pound. For whey, Land O'Lakes recommends that USDA set a make allowance above the cost of drying NFDM and at a rate consistent with the testimony and recommendations of Northwest Dairymen's Association and Leprino Foods. We recognize that this request represents a 31.7 percent increase in the butter make allowance; a 33.4 percent increase in the NFDM make allowance and an 8.7 percent increase in the cheese make allowance. We also point out that the testimony today represents an updating of costs over a six year period. Additionally, the evidence presented in 2000 contained an error, so it is quite reasonable to conclude that the make allowances for butter and powder have been understated during the entire period.

In the last Make Allowance Hearing, IDFA spent considerable time arguing that the Department should attempt to err on the high side when calculating the make allowances. While Land O'Lakes is a major manufacturer of butter, powder and cheese within the Federal Order system, it is also a cooperative. Our dairy farmer member-owners rely on a milk price for their living and they also expect that their investment in manufacturing assets brings a return. I would recommend to the Secretary to be like Goldilocks and get the make allowances "just right." Given that the CCC clears the market of excess butter, powder and cheese, it would be to no one's advantage in the industry to set a commodity's make allowance so high that milk flows to producing that commodity, irrespective of external market signals. On the other hand, setting make allowances too low discourages investment in the assets needed to clear the market on a daily, seasonal and annual basis. The costs of maintaining market balancing facilities must be borne by the market, not only by the owner of the facilities.

Land O'Lakes is well aware of the class price decreases that would follow from our support of the AgriMark proposal is \$0.46 in Class III price and \$0.51 in Class IV. While Land O'Lakes membership isn't happy about the changes, they recognize that they are currently paying for these increased plant costs, while the larger producer market avoids them by not owning

plants. We also recognize the longer term and more expansive analysis provided by USDA in the Notice of Hearing.

USDA's three scenarios offer insights into the producer price impacts of the changes in make allowances. Scenarios two and three increase the cheese make by 3.5 cents (from current levels) and 5 cents (from current levels) which is far above our proposed increase of 1.44 cents. All three USDA scenarios increase the butter make 4.11 cents which is also above our proposed change of 3.68 cents. Additionally, we propose to increase the NFDM make by 4.67 cents and the whey make by 5.27 cents compared to USDA's scenarios of an increase of 2.15 cents on NFDM and 1.59 cents on whey.

USDA's scenarios give us an idea of how varying the cheese make allowance impacts producer prices and a bit of an idea of how changing the other makes will impact producer prices.

We would expect the impacts of AgriMark's proposal on producer milk prices to fall within the ranges estimated by the USDA. Like the USDA estimates, we would expect the impact on class prices to be the largest immediately following the changes in make allowances. In accordance with the Department's model we would expect wholesale product prices to increase and get passed along to producers through the classified pricing formulas. We would not anticipate the longer term impact of our proposed changes to far exceed the price impacts on the all milk price estimated by USDA in Scenarios 2 and 3. We also must point out that any impacts to producer blend prices by decreased Class I prices would be mitigated by the MILC program, which is not factored in the USDA analysis.

In anticipation of questions regarding Land O'Lakes financial condition, I present the following. During 2004 the Dairy Foods division of Land O'Lakes reported pretax earnings of \$16.4 million. This amount includes the operations of the cooperative's value added and industrial divisions. While Land O'Lakes has a policy of not reporting in detail of its individual plant operations, I can say that each of our butter, powder and cheese plants, included in the RCBS survey, lost money in 2004, even given the fact that the average selling or transfer price at each of the four plants was above the NASS average for the year and assuming no procurement costs were allocated to the plant. Even though the whey operation reported a profit, the cheese-whey operation reported a loss; and the favorable transfer price

between the Denmark and Greenwood plants and Kiel was very likely an important factor in Kiel's whey profitability.

Need for an Emergency-Expedited Decision on Updating the Cost Indices

The testimony given today highlights the increase in costs incurred by butter, powder, cheese and whey plants since 1998-9, when USDA last set make allowances based on the manufacturing costs of those years. Additionally, the defect in the testimony presented in the 2000 further highlights the need for the Department to update the butter and powder make allowances based on the most recent cost surveys because there is a question whether those make allowances are currently in error. We request that the Department issue a rule without a recommended decision.

Land O'Lakes wishes to thank the Secretary and his staff for the expedited manner in which this hearing was called and look forward to a timely decision.