

UNITED STATES DEPARTMENT OF AGRICULTURE
BEFORE THE SECRETARY OF AGRICULTURE

In re:	)	Docket Nos. AO-14-A74, et al.; DA-06-01
Milk in the Northeast and	)	
Other Marketing Areas	)	
	)	

POST-HEARING BRIEF OF THE NATIONAL CHEESE INSTITUTE

This post-hearing brief is submitted with respect to the re-opened hearing held September 14-15, 2006, to consider proposed changes to all federal milk marketing orders in the make allowances used in all class price formulas. This was a continuation of the hearing held on January 24-27, 2006.

The brief is submitted on behalf of the National Cheese Institute (NCI), a trade association representing manufacturers, marketers and distributors of cheese and related products. NCI's approximately 70 member companies manufacture and/or market more than 80% of the cheese consumed in the U.S. As buyers and processors of milk, members of NCI have a critical interest in this hearing. Most of the milk bought and handled by NCI members is purchased under the Federal Milk Marketing Orders (FMMOs) promulgated pursuant to the Agricultural Marketing Agreement Act of 1937 (the AMAA).

Based on the record presented at the hearing, NCI strongly urges USDA to change the make allowances used to calculate minimum prices for all classes of milk under FMMO regulation as follows:

1. The make allowance for Cheddar cheese in the protein price formula should be set no lower than the Cornell research estimate of the weighted average costs of processing for the population of dairy manufacturing plants located outside of California --\$0.2028 -- PLUS the marketing cost of \$0.0015, PLUS the Cornell research estimate of the impact of higher energy costs in 2005 -- \$0.0034. The make allowance should therefore be no lower than 20.77 cents per pound of Cheddar cheese.

2. The make allowance for dry whey in the other solids price formula should be set no lower than the Cornell research estimate of the weighted average costs of processing for the population of dairy manufacturing plants located outside of California (based on the sampled plants) --\$0.1941 -- PLUS the marketing cost of \$0.0015, PLUS the Cornell research estimate of the impact of higher energy costs in 2005 -- \$0.0076. The make allowance should be no lower than 20.32 cents per pound of dry whey.
3. The make allowance for butter in the butterfat price formula should be set no lower than the Cornell research estimate of the weighted average costs of processing for the population of dairy manufacturing plants located outside of California (based on the surveyed plants) -- \$0.1108 --PLUS the marketing cost of \$0.0015, PLUS the Cornell research estimate of the impact of higher energy costs in 2005 --\$0.0029. The make allowance should be no lower than 11.52 cents per pound of butter.
4. The make allowance for nonfat dry milk in the nonfat solids price formula should be set no lower than the Cornell research estimate of the weighted average costs of processing for the population of dairy manufacturing plants located outside of California (based on the surveyed plants) -- \$0.1423 -- PLUS the marketing cost of \$0.0015, PLUS the Cornell research estimate of the impact of higher energy costs in 2005 --\$0.0070. The make allowance should be no lower than 15.08 cents per pound of nonfat dry milk.

Emergency Action Needed. NCI notes that USDA first received a petition for an emergency hearing in September 2005, one year ago, to update the make allowances used in all Federal milk marketing order class price formulas. It has been eight months since a hearing was first held to consider proposals to do so. At that January 2006 hearing, numerous witness from companies and cooperatives with dairy product manufacturing plants testified regarding the need for emergency action by USDA to address rapidly escalating costs of manufacturing. In addition, witnesses with direct responsibility for the collection of data on industry costs of processing from both the California Department of Agriculture and USDA's Rural Business Cooperative Service testified about the most recently available data from the same sources of information used to set the current make allowances. NCI was quite disappointed when USDA

announced on June 28, 2006 its intent to reconvene that hearing to take additional testimony on costs of processing, which has prolonged the serious industry problem of having no means to address higher costs of processing under existing Federal milk marketing order class price formulas. NCI urges USDA to quickly publish and implement a decision based on the full hearing record to address this very serious industry problem.

Costs of Processing Estimates. The hearing held September 14-15, 2006 was a reconvening of the hearing held January 24-27, 2006 to consider proposals to amend the Class III and Class IV milk price formulas make allowances applicable to all Federal milk marketing orders. The notice to reconvene noted that this hearing would take into evidence only data on plant manufacturing costs compiled by Cornell University and any other pertinent data or information specifically addressing plant manufacturing costs that would be publicly available. The only witness at the reconvened hearing which presented publicly available data on the costs of processing in manufacturing plants was Dr. Mark Stephenson from Cornell University.

Dr. Stephenson from Cornell University testified regarding the results of research into the costs of processing in Cheddar cheese, whey, butter and nonfat dry milk plants. USDA's June 28, 2006 notice of intent to reconvene noted, "The data being collected by Cornell University represents a cross-section of the entire dairy industry--large, medium and small plants from various geographical regions. Because of the significance of make allowance factors in Class III and Class IV pricing formulas on the dairy industry, the Department wants to be certain that the best possible data is available in making a decision concerning any possible changes." NCI believes the industry need for relief was too great to wait more than seven months since the January 2006 hearing for this research to be completed before a decision was made. However, we note the Cornell research was funded by a grant from USDA and we agree with the USDA that the data is representative of the dairy manufacturing sector outside of California and includes all costs of processing. In fact, it is the only publicly available data meeting those criteria, and therefore provides an appropriate starting point for calculating make allowances.

Dr. Stephenson himself explained in great detail that the research design for this USDA-funded project requires that the average costs of processing for the Cheddar cheese plants in the survey sample be corrected for the sampling design in order to determine the weighted average costs of processing for the entire population of Cheddar cheese plants outside of California. Specifically, in the case of Cheddar cheese, the USDA agency which funded the Cornell research

provided data on individual plant volumes, which allowed Dr. Stephenson to engage in a stratified sampling of plants. Through this stratified sampling technique, Dr. Stephenson was assured of including in his survey a significant number of larger, presumably more efficient, Cheddar cheese plants.

However, as Dr. Stephenson himself noted, it is improper to rely solely on the weighted average cost of processing of the sampled plants, because his use of stratified sampling resulted in an over-sampling of the stratum that contains the largest plants. A weighted average cost of processing that is based only on the sampled plants accordingly is improperly skewed in the direction of the costs of processing of those largest plants and is not representative of the broader processing population.

Fortunately, as Dr. Stephenson observed, the USDA data on individual plant volumes could be, and was, used by Dr. Stephenson to adjust the survey results in order to calculate a weighted average cost of processing estimate for the entire population of “commercial” Cheddar cheese plants outside of California. (Commercial plants are those that produce at least 1 million pounds of cheese a year, per Dr. Stephenson’s written testimony).

As Dr. Stephenson pointed out, this adjustment is absolutely necessary in order to make inferences about the population parameters (that is, the population of all commercial Cheddar cheese plants outside of California), since the stratified sampling approach he used necessarily resulted in sample statistics which were not representative of the entire population of all commercial Cheddar cheese plants outside California. And, it is the estimate of the weighted average cost of processing for that population of plants that provides the basis for setting make allowances.

It is, therefore, Dr. Stephenson’s final calculation -- \$0.2028 per pound -- that represents, as he himself labels it, the “Weighted Average Processing Costs for Cheddar Cheese” plants outside of California. In fact, Dr Stephenson explicitly testified at the hearing that if he had to pick one value to represent the cost of processing cheese, it would be 20.28 cents per pound. That number is the proper starting point for setting the make allowance for cheese.

NCI considers it unfortunate that similar individual plant volume data was not available for the population of dry whey, nonfat dry milk, and butter plants. As seen in the attached table, differences exist between the population of average plant size as reported by USDA's National Agricultural Statistics Service (NASS) and the Cornell sample statistics; the same applies to the

cost of processing data published by the California Department of Food and Agriculture (CDFA) for plants located in that state. For Cheddar cheese, the national, annual average volume per plant reported by NASS is about 18 million pounds, while the sample statistic for the Cornell research is more than three times greater, over 60 million pounds, and the average for the CDFA cost study is nearly 7 times higher at almost 117 million pounds. While the differences between the national average reported by NASS and the Cornell sample are smaller for dry whey, nonfat dry milk and butter, they are still significant.

In the absence of individual plant volume data, however, it is necessary to rely on the Cornell study's weighted average costs of processing for the sampled dry whey, nonfat dry milk and butter plants, without adjustments to reflect the actual populations of dairy manufacturing plants located outside of California, as the starting point for setting the make allowances for dry whey, nonfat dry milk and butter. One must recognize that this approach results in sample estimates of make allowances that are unduly low with respect to dry whey, nonfat dry milk and butter, because given their size, the weighted average costs of processing for the sampled dry whey, nonfat dry milk and butter plants will be lower than that of the entire population of dry whey, nonfat dry milk, and butter plants outside of California.

Marketing and Sales Costs. The Cornell cost of processing estimates for all dairy products should be adjusted for the fact that the wholesale sales value for manufactured dairy products 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. USDA concluded following the May 2000 hearing to add a marketing cost of \$0.0015 to the weighted average costs of processing for both the RBCS and CDFA data, since neither cost data included marketing and sales related costs. In addition, Dr. Stephenson agreed that his study of costs of processing did not include marketing and sales costs for the finished manufactured products. NCI urges USDA to add this adjustment to the Cornell research estimate of the average costs of processing for the population of dairy manufacturing plants which, like the CDFA cost of processing study, does not include this cost.

Energy Costs. Finally, USDA must account for the very real fact that costs of manufacturing have escalated since the period the Cornell data was collected. As Dr. Stephenson testified, at least 84% of the monthly data submitted for the Cornell research were for months prior to July 2005, more than 14 months ago. The problems experienced by dairy

manufacturing plants, both cooperative-owned and proprietary, prior to the January 2006 hearing were testified to by numerous representatives of dairy manufacturing plants.

Dr. Stephenson in fact examined this very important factor of the impact of energy costs on the costs of processing in his testimony. Dr. Stephenson combined data from the Bureau of Labor Statistics' published producer price indexes (PPI) for industrial electric power and natural gas with data from the energy cost estimates from the Cornell research to estimate the impact of higher energy costs in 2005 on the costs of processing. USDA should add these energy cost updates to the Cornell costs of processing to insure that the make allowances adopted by USDA reflect the most current data available on the costs of processing.

USDA Must Take Care Not To Set Make Allowances Too Low. In setting make allowances, USDA must bear in mind the tremendous problems it would create if it were to set make allowances that are too low as compared to actual costs of manufacturing. At the hearing held January 24-27, 2006, numerous witnesses testified to the nature of the price formulas used in FMMOs since January 1, 2000, which result in fixing the margin between the price manufacturers receive for the dairy products they produce and the minimum price they must pay for the milk used to make those products (Yonkers, Wellington, Schad, McBride, Cryan, and McCully). At that time, USDA adopted a system of product price formulas which utilize the price of finished products to determine the minimum milk prices that must be paid to farmers. Since April, 2003, these make allowances have been based on industry cost data from 1997-1999 presented at a May 2000 hearing. Oversimplifying slightly, a product price formula sets the minimum prices that farmers must be paid for their milk 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").

Therefore, the make allowance is the fixed difference between the wholesale sales value of a manufactured dairy product and the minimum regulated 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.

Wellington noted that “Manufacturing allowances that are fixed in the class pricing formulas bear no relationship with the selling prices of any of the dairy products mentioned or the prices received by farmers for their milk. If cheese, butter, nonfat dry milk (NFDM) and whey powder prices were to double tomorrow, Class III and IV prices and farm prices would more than double, but manufacturing plants would receive the exact same allowance. In fact, manufacturing costs for energy, insurance, labor, capital and/or any other input could double yet the manufacturer would not get one penny more to cover those costs under the existing order provisions.”

Schad noted that “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.”

McCully noted that “Unfortunately, with the adoption of the current make allowances in April 2003, coupled with dramatically higher costs over the last several years, the manufacturing sector has suffered. Prior to 2000, Kraft was concerned the adoption of product formulas to price milk would lead to the very problems we've seen over the past few years. The issue we are discussing at this hearing specifically addresses the inability of manufacturers to cover increased costs through the sale of finished products. If manufacturers attempt to do this, the circularity of the formula results in the milk cost increasing by the same amount, and thus not recouping their higher costs.”

Cryan noted that “Federal order milk prices are minimums, so that if the demand for milk is strong enough, the market will produce price premiums above the USDA-set minimum. By contrast, make allowances define a maximum milk-to-cheese margin that the average cheddar cheese maker, for example, can get for his trouble. Since the current formulas define milk prices as a fixed function of the product prices, the milk price rises when the average product price rises. If the fixed margin becomes inadequate to cover costs for the average plant, there is no room for processing premiums. That is, while market forces can correct regulated milk prices that are too low, the make allowance can only be adjusted by USDA. Under current conditions, these make allowances are too low. This undermines the ability of Federal order-regulated plants to operate. This, in turn, undermines Federal orders, which rely on manufacturing plants, including especially cooperative plants and cooperative-supplied plants, to balance overall milk

supplies. If those outlets are pushed into state-regulated and unregulated markets, they cannot effectively provide those services, putting all participants in Federally-regulated markets at a disadvantage.”

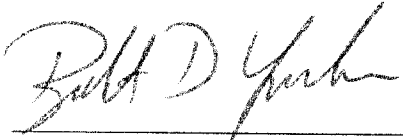
There were no witnesses for companies which manufacture Class III and IV products who did not note the problems created when manufacturing margins are fixed and manufacturing costs beyond their control increase. Wellington, representing a cooperative, in particular noted that the losses created from this problem are borne unequally by producers when those producers are members of a cooperative which owns and operates plants which process Class III and IV products.

At the reconvened hearing, Dr. Stephenson noted that for cheese, his estimate of the weighted average cost of processing for the population of cheese plants located outside of California would fail to cover the cost of processing for about 67 percent of such plants. Thus, there can be no basis to argue that the make allowances being urged by NCI, based on the Cornell data, are too high. If anything, they are too low, especially for the reasons described above with respect to whey, butter and non fat dry milk.

No Other Witnesses Presented Publicly Available Costs of Processing Data. None of the other witnesses to appear at the hearing September 14 and 15, 2006 presented any data on the costs of processing for manufactured dairy products. The testimony of Dr. Roger Cryan was limited to the potential use of energy cost indices with respect to the cost of processing data presented by Dr. Stephenson, not on the actual costs of processing data itself. Dr. Ken Bailey noted that he had not performed any analysis of the costs of processing in dairy manufacturing plants. Furthermore, his analysis was based on future price projections that he admits have been unreliable in the past. Dr. Donald DeJong stated he had no firsthand knowledge of the costs for processing in dairy manufacturing plants in which his cooperative has a financial interest. Pennsylvania Secretary of Agriculture Dennis Wolff presented no costs of processing data in his testimony.

Conclusion. The dairy manufacturing sector desperately needs USDA to finish the process initiated by a petition filed one year ago in September 2005. USDA should make these proposed changes to the make allowances in the Class III and IV price formulas as used in all classes of milk as soon as possible on an expedited basis. The hearing record unequivocally establishes that manufacturing costs have increased significantly since the cost surveys that were

used to establish the current make allowances. The current structure of the federal order system requires that the make allowances be adjusted as needed to reflect true costs. USDA should omit a recommended decision and act as expeditiously as reasonably possible to do so. USDA should set per pound make allowances no lower than the following: cheddar cheese, 20.77 cents per pound; butter, 11.52 cents per pound; nonfat dry milk, 15.08 cents per pound; and dry whey, 20.32 cents per pound.

A handwritten signature in dark ink, appearing to read "Robert D. Yonkers", written over a horizontal line.

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