

**UNITED STATES DEPARTMENT OF AGRICULTURE
BEFORE THE SECRETARY OF AGRICULTURE
Agricultural Marketing Service – Dairy Programs**

<u>In re:</u>)	
)	
Milk in the Northeast and)	
Other Marketing Areas)	Docket Nos. AO 14-A69, <i>et al.</i> ;
)	DA-00-03
Class III/IV Milk Prices and)	
Make Allowances)	

**COMMENTS AND EXCEPTIONS OF
KRAFT FOODS ON THE RECOMMENDED DECISION**

I. INTRODUCTION

Kraft’s post-hearing brief of July 14, 2000, focused on the legal standards for ratemaking, and urged the Department of Agriculture to be guided by the long experience of traditional rate-making agencies in the Department’s new venture to regulate manufacturing margins for dairy product plants. The Recommended Decision, 66 Fed. Reg. 54064 (October 25, 2001)(“Decision”), neither acknowledges the body of universal legal principals that have been developed in other ratemaking settings nor follows the exacting ratemaking standards that have evolved over a century of trial and error.

The analytical approach of the Recommended Decision compounds the difficulty experienced by industry participants in attempting to provide material evidence and comments on manufacturing margin issues in the Federal Order

Reform process, and in reconsideration of Class III and IV margins in this proceeding, without clear advance notice of standards governing the decision to be reached.¹

As recently reemphasized in *Michigan Bell Telephone Co v. Engler*, 257 F.3d 587 (6th Cir.2001), a regulated rate is not constitutionally adequate if it “merely permits telephone service providers to cover costs, and does not ensure a fair and reasonable rate of return on investment.” *See also, Canadian Association of Petroleum Producers v. FERC*, 254 F.3d 289, 297-8 (D.C.Cir. 2001); *Missouri Public Service Commission v. FERC*, 234 F.3d 36 (D.C.Cir. 2000). As described below, the Decision neither allows neither cheesemaking cost recovery nor a reasonable return on investment.

The Decision properly concludes, as a matter of policy, that the make allowances incorporated in the component price formulas under the Federal milk orders should cover the costs of most of the processing plants that receive milk pooled under the orders. Decision at 54073-74. This conclusion is expressed as a policy choice, to allow the market to clear, rather than as a mandate of ratemaking law. *Id.* The Decision further observes that a plant’s economic

¹ As with the Federal Order reform rules which Congress found to be unanticipated by proposals, the Recommended Decision is significantly different from the proposals published in early 2000, upon which the parties relied in presenting evidence and analysis. The proceeding, therefore, should be reopened to permit parties to present evidence and argument responsive to the agency’s new views on facts and policies relevant to its consideration.

“break-even point would be where the value of cheese plus whey cream plus whey powder equals the value of the milk price plus the make allowances.” *Id.*, 54087. The Decision describes the differences between regulated milk prices and imputed product revenues as “gross margins.”² Although the Decision calculates that USDA’s proposed rule would reduce cheesemakers’ gross margins by 16% (*id.*), it nevertheless expresses a “*belie[f]* that the margins allowed for cheesemakers under these recommended price formulas *should be* entirely adequate for them to maintain their operations.” *Id.* at 54086 (emphasis supplied). Because the plant cost surveys upon which USDA relied were weighted averages, it is not even possible to know from the record whether the margins allowed reflect the experience of smaller plants that were part of the survey, much less whether they are sufficient for the majority of plants, many of which are small business, that were not part of any survey.

However, a mere “break even” regulated price is, as a matter of law, Constitutionally inadequate under standards of *Federal Power Commission v. Hope Natural Gas Co.*, 320 U.S. 591 (1944), as explained in *Guaranty National Insurance Co. v. Gates*, 916 F.2d 508, 515 (9th Cir. 1990). The standard of law,

2 “[G]ross margins are defined as the difference between the sum of the selling price of cheese and dry whey based on monthly average NASS prices and whey butter, estimated at nine cents below the NASS AA butter price, and the cost of milk under the two sets of formulas. The gross margins therefore reflect the amount of money available to processors to procure, process, and market the end products of milk used in Class III: cheese, whey butter and dry whey.” Decision at 54087.

moreover, is not satisfied by conclusory “belief” about the result of cost recovery or profitability margins the regulated rates “should” produce.

As acknowledged in the Decision (at 54087), the regulated margin may represent something more than the express make allowance for cheese. But every component of the formula has the practical effect of enhancing or contracting the make allowance. Survey prices used, for example, will reduce the effective make allowance if price assumptions overstate commodity revenue. Yield factors will reduce the effective make allowance if the formula assumes more products are produced and sold than actually experienced by most plants. And any component of cost not included, or inadequately captured, in the make allowance will reduce gross margins and threaten adequate return on investment.

The Decision’s analysis calculates product or component yields to the third or fourth decimal, product or component prices to the mil or deci-mil, and plant costs to the hundredth cent. By this superficially more exacting estimate of costs and revenues, the Decision concludes that regulated margins may rationally be reduced. But this micro-managed approach, operating near the precipice of unreasonable rates, also creates greater risk that a cost understated by a few mils, revenue overstated by a few mils, yields overstated by a few ounces, or a relevant consideration overlooked, will produce an unlawful result.

The Decision on Class III prices and manufacturing margins, as described below, would produce rates that cross the Constitutional and statutory line.

The Decision purports to incorporate in the cheese make allowance a calculated return on investment (ROI) of 1.03 cents per pound, deferring to the ROI factor used in California rather than making any independent ROI findings for plants that receive federal order Class III milk. Decision at 54082. Thus, if any portion of the Class III formula overstates commodity revenue, overstates yields, or understates costs, it will directly reduce the imputed ROI of a penny. The error of one penny per pound of cheese in any component of the formula, or in the aggregate, will wipe out ROI and render the Decision facially unconstitutional under standards of *Hope Natural Gas* and its progeny.

II. THE PROPOSED RULES OVERSTATES COMMODITY PRICES

A. Barrel Cheese Prices are Overstated In the Formula by 2¢.³

The use of barrel cheese prices in the Class III formula is of critical importance to a reasonable gross margin for cheese plants. Barrel cheese in 500 pound containers make up two-thirds of cheese in the price survey.

³ While we focus in this argument on use of reported NASS barrel cheese prices in the product price formula, it should be observed that neither NASS block and barrel prices, nor CME reported prices, make any allowance or adjustment for the commercially indisputable fact that some product sales included in the survey will be later downgraded, rejected by the buyer, or otherwise price-adjusted after delivery pursuant to terms of contract or Article 2 of the Uniform Commercial Code. To accommodate this commercial fact, the NASS survey questionnaire should add a question to produce the per pound value of price adjustments in cheese previously reported as sold.

Additionally, cheddar cheese in 640 pound blocks are not included in the survey, but represent 20 – 25% of all American cheese produced in the United States.

Decision at 54080-81.

In exceptions to the Tentative Final Decision, IDFA/NCI and numerous cheesemakers argued that the barrel cheese price, as carried forward to the Decision, was overstated by at least two cents because the reported price was adjusted from 39% moisture to 38% moisture (adding two cents) and an additional three cents is added after this adjustment, which again includes a value for moisture. The Decision, in effect, *increased* the barrel price adjustment in the Federal Order Reform Decision from 3 cents to 5 cents. Based on weighted cheese volume, this dispute over 2 cents represents 1.32 cents in the make allowance, and would convert the computed ROI to a negative .29 cents per pound.

There is no genuine dispute that a reduction in barrel cheddar moisture increases product value.⁴ This accounts for the long-term lower price of barrel cheese at 39% moisture compared to block cheese at 38% moisture.

⁴ By letter-notice to the cheese industry dated December 7, 2000 (D&DOD-85), USDA's Farm Service Agency, Kansas City Commodity Office, gave notice that cheese purchased by the Commodity Office would be price adjusted for moisture by the following formula: $100\% - \% \text{moisture} \times \text{base price} \div 61\%$. In the example provided, the price of 37.7% moisture cheese would increase by 2.39 cents where the cheese base price was \$1.1220 per pound. CME rules for cheese trading, Rule S_04.A and Chapter S notes to Rule S_04.A also provide a similar formula for cheese with less than 37.7% moisture.

To the extent that the Decision attributes some of block and barrel price differences to factors other than moisture, its conclusions appear to be based not on substantial record evidence, but rather on assumptions for which the hearing notice gave no warning, and concerning which participants (not surprisingly) failed to disprove in the negative.

The Decision criticized cheese plant witnesses that produce both block and barrel cheddar, complaining that: “none of them addressed the actual cost differences of packaging and manufacturing 40-pound blocks and 500-pound barrels. Instead, the only testimony that was offered involved attributing a 2-cent difference to the moisture-adjusted value of the two sizes of cheese packages.” Decision at 54081. Finding inadequate rebuttal for its apparent (and unannounced) predisposition to find a non-moisture basis for the market price spread between block and barrel cheese, the Decision concluded: “The record contains no basis for concluding that the actual cost of manufacturing and packaging the two sizes of cheese is not the historical 3- cent price spread.” *Id.* If this is so, no moisture adjustment is justified.

A significant problem with such negative rather than affirmative fact-finding is that the barrel/block price spread, prior to federal order reform, has not been used for purposes of fixing manufacturing margins. And in the notice and comment reform process, it was at best a contested evidentiary fact for

which no opportunity existed to test assumptions by cross-examination of witnesses. The only record evidence upon which USDA may reasonably rely for purposes of regulating manufacturing margins based on block and barrel price differences is in this record. And on this record, at least 2 cents of the 3 cents historical spread between barrel prices and block prices is accounted for by moisture, and is therefore also already accounted for when NASS survey barrel prices are adjusted to 38% moisture.⁵

Kraft adopts and incorporates the Comments and Exceptions of Leprino Foods and IDFA/NCI addressing additional details of barrel and block price issues.

B. Whey Cream Values Are Overstated in the Formula.

The Class III formula reasonably recognizes that 90% of butterfat in producer milk is recovered in cheese. Much (but not all) of the remaining fat is contained in whey cream, a cheese making by-product. The decision also estimates that the value of whey butter is 9 cents below the Grade AA butter price, Decision at 54087, and evidence demonstrates an even greater (40¢) price difference. Reinke, Tr. 1041. However, the recommended rule prices all Class

⁵ As to container or packaging costs for barrel cheese, CME trading rules, Rule S_08, allows a barrel charge of \$ 5.00 (i.e., one cent per pound cheese) for non-steel containers, and provides for a deposit on steel containers, with the seller responsible for excess freight on return of the container. To the extent there is any difference in actual make costs for barrel cheese prior to packaging, it is not revealed in this record. However, if assumed (lower) cost differences are included in the agency's 3-cent adjustment, the gross margins of cheese makers will be unreasonably contracted.

III fat at the Class III/IV fat price, with an adjustment for fat value in the protein price. The portion of fat that ends up in whey – about 1/3 lbs fat per cwt producer milk -- is priced as though used in butter.

When the butter price is \$ 1.30/lb., and the Class III fat price is \$ 1.445, the formula applied to fat not recovered in cheese overstates manufacturer revenue (or understates costs) by 3.2 cents per hundredweight of producer milk. This also has the effect of reducing the ROI on cheese by 0.32 cents per pound – representing almost one-third of the ROI factor in the formula.⁶

Kraft adopts and incorporates the Comments and Exceptions of Leprino Foods and IDFA/NCI addressing additional details of whey cream pricing issues.

III. THE DECISION OVERSTATES PRODUCT YIELDS

Much debate is contained in the hearing record, briefs, comments and decisions concerning cheese yields from farm milk at test, or from milk standardized to 3.5% fat. The Van Slyke formula, or modifications thereof, make necessary assumptions about casein to protein, true protein to total protein, and protein to fat efficiency. As explained in the Decision, the price calculation includes a multiplier 1.405 that was, in turn, derived from rounding cheese yield

⁶ Not included in this price overstatement or cost understatement analysis is the fact that although all fat in Class III producer milk is priced, some fat is lost in handling and manufacturing and recovers no revenue whatsoever; and a small amount is contained in whey powder at a value of about 10% of the butter price.

factor per point protein from 1.318 or 1.316 to 1.32. Decision at 54083. The Decision proceeds to explain:

Regardless of which procedure is used, assumptions must be made with regard to the various factors used in the formulas. These assumptions directly affect the outcome of the factors used in the protein formula and the resulting protein price and value.

Id.. Assumed laboratory compositions and yield truisms upwardly rounded for agency convenience are nevertheless altered in real life by variations, however slight, between plants, regions, herds, seasons, climates, and the like.

The most significant predictor of cheese yield is casein composition. Since casein is not readily tested in producer milk, true protein content is used as a proxy. The Class III protein price and cheese yield formulas appear to assume a fixed ratio of 83.3% casein to true protein, though the Decision explains this obliquely rather than directly. Decision at 54083. The record evidence reveals that casein to true protein in producer milk averages about 82.2%, but ranges from 82.12% to 82.42% by year, region, season and the like. Barbano, Tr. 555, 698, 766.

As described in more detail in the Comments and Exceptions of Leprino, adopted and incorporated herein, a very small difference in calculated or assumed cheese yield per pound true protein will have a significant effect on margins and prices. A mere change of one point in the casein to true protein ratio, from 82.2 to 82.1 or 82.3, will affect calculated yield by 0.017 lbs cheese

per pound protein. A mistake, rounding, or overestimate of one point in casein will therefore overstate imputed cheese revenue and reduce gross margins under the formula by the calculated value of protein in 0.017 lbs cheese. This margin of error, or of regulatory indifference to consequence, cannot be tolerated where the imputed ROI is only a penny per pound of cheese.

The Decision characterizes the protein factor criticisms in Leprino's comments to the Tentative Decision as a "not significant[]" difference between 1.405 and 1.3997. Decision at 54084. However, applied to the formula, the difference amounts to about one-half cent per pound of cheese. The effect of this is not at all insignificant to the imputed penny ROI. It would cut return on investment in half.⁷ For reasons explained in greater detail in the Comments and exceptions of Leprino and IDFA/NCI, USDA should replace the 1.405 cheese yield factor in the protein price formula with a factor not greater than 1.385.

⁷ The Decision, at 14083, also seeks to justify the rounded yield factor based on prior use as part of a competitive milk price formula: "The 1.32 factor was used in the protein price formula in the Federal order reform proposed rule and in the five Upper Midwest markets beginning in January 1996 to compute the protein price prior to Federal order reform. The 1.32 yield factor generally has been accepted as an appropriate factor to use for computing a protein price." The current use of this factor as part of a regulated manufacturing margin is far different, conceptually, legally and economically. As a consequence of manufacturing margin regulation since January 2000, handlers may no longer make competitive corrections in product prices without also bootstrapping their own regulated milk costs.

IV. THE DECISION FAILS TO ACCOUNT FOR, OR UNDERSTATES, SIGNIFICANT COST FACTORS.

To the extent that the Decision acknowledges and accounts for actual categories of cheese manufacturing costs in its Class III formula, the driving regulatory philosophy appears to one that will minimize or reduce margins under which cheese plants have operated in the past, and preclude at least half of all plants making commodity cheddar cheese from recovering costs and a reasonable return on investment. The cost surveys on which USDA relied primarily address averages of selected costs in larger, more efficient plants. The surveys are weighted by production volume, to produce bias against the actual costs of smaller plants in the survey. The experience of small business cheese plants was not developed by the RBCS survey, nor independently studied by the Dairy Programs Branch. The conclusions of the agency that the proposed rule “should not raise barriers to the ability of small handlers to compete in the marketplace” (Decision at 54066), and that the Class III formula “should cover the costs of *most* of the processing plants that receive milk pooled under federal orders” (*id.*, 54074, emphasis supplied, 54086-87), are not supported by reference to the record. Nor is there, in fact, any record evidence to support these conclusions.

Although the RBCS and CDFAs surveys reveal a significant and variable range of costs, the Decision errs on the side of cost exclusion rather than

inclusion by employing weighted cost averages assuring that half of even the few plants surveyed will not recover costs in the manufacturing allowance. For example, the most efficient three of the nine cheese plants included in the CDFA survey experienced cheese processing costs averaging 15.46 cents per pound cheese, while processing costs were 21.33 cents per pound for the three highest cost plants. The RBCS survey of 1998 plant costs at 12 cheese plants was less revealing,⁸ but Dr. Ling acknowledged that, based on limited cost factors included in the survey, cheese make costs ranged by 8.145 cents from the low cost plant to the high cost plant, and skim milk powder costs ranged by over 11 cents per pound. Ling. Tr. 158. The witness declined to reveal actual high and low costs represented by this range, and did not disclose average (non-weighted) or median plant costs. From these data, it is nevertheless apparent that USDA could substantially increase the regulated manufacturing margin and still leave many plants with unrecovered costs and no return on investment.

On some specific factors not included in the surveys, USDA consciously selected a cost allowance less than actual costs experienced by plants receiving

⁸ The Decision repeatedly touts the RBCS survey as one derived from 16 years of experience and “as accurate as possible.” Decision at 54074. However, the survey evidence only provides *some* 1998 costs. Survey data from the prior 15 years were not produced because AMS did not ask for them (Tr. 135). The witness further refused to provide prior years’ data or answer questions about prior years because RBCS considers the surveys confidential, even in redacted or average form. Ling, Tr. 70-71, 122-24, 135-137, 199. This agency-created limitation of full disclosure of available facts raises serious questions of lawful procedure under the Due Process Clause and the Administrative Procedure Act, 5 U.S.C. §556(d) (“A party is entitled to . . . conduct such cross-examination as may be required for a full and true disclosure of the facts.”).

federally-regulated milk. In its allowance of a return on investment of a penny per pound of cheese, moreover, USDA did not make any independent study, finding, or inquiry of cheesemakers' return on equity "commensurate with returns on investment in other enterprises having corresponding risks," as required by *Federal Power Commission v. Hope Natural Gas Co.*, 320 U.S. 591, 602 (1944).⁹ Rather, USDA simply deferred to state agency findings of CDFR, which in turn do not appear supported by *Hope* ROI standards.

One of the most significant omissions in the rate formula adopted by the Decision is its failure to account for fat, protein and other solids that is tested at the farm, but is not actually contained in any product producing revenue. The formula prices all components of farm milk in cheese or cheese by-products. The formula effectively assumes that all milk components purchased from producers are marketed. There are, indisputably, losses and shrinkage of milk components between the farm and the loading dock from which finished products are transported for sale. The Decision asserts, without supporting reference to product prices or specific product and by-product yields, that the

⁹ A return on investment sufficient to satisfy *Hope Natural Gas* standards is so important to lawful ratemaking that ROI, rather than costs, is frequently the principal factual issue involved in a contested rate proceeding. See *In re Transcontinental Gas Pipe Line Corp.*, Docket No. RP95-197-052, Opinion 414 (Federal Energy Regulatory Commission, August 1, 1997); *In re Kansas Pipeline Company*, Docket No. CP96-152-028 (97 FERC ¶ 61,168, November 9, 2001), on remand from *Missouri Public Service Commission v. FERC*, 234 F.3d 36 (D.C.Cir. 2000).

RBCS and CDFA production cost surveys and USDA's yield formulas

somehow factor-in component shrinkage:

The component pricing formulas are based on the content of those components in the finished products for which a manufacturing cost per pound has been established. Both the CDFA and RBCS *cost surveys allocate all plant costs to actual end products, a process which should take shrinkage into account*. Similarly, the yield factors in the formulas refer to the amount of finished product resulting from the processing of a given volume of input or to the amount of component present in the finished product. Both of these factors in the pricing formulas include consideration of shrinkage.

66 Fed. Reg. at 54075 (emphasis supplied). The agency's confidence that the price surveys *should* account for shrinkage is not supported by any explanation of *how* they may in fact do so. The cheese surveys reveal something about yield of cheese from milk placed into the vat. The only "actual end product" addressed in the cheese plant surveys is cheese. The cheese plant surveys reveal nothing about, and do not account for, fat and protein shrinkage between the farm tank and the vat. Likewise, they reveal nothing about, and do not account for fat, protein and other solids discharged in whey or down the drain.

The Class III pricing formula does account for farm milk components *not* contained in cheese, but in so doing assigns a finished by-product disposition to all such components, leaving no room for shrinkage.¹⁰ The milk components

10 The fact that milk orders have "always provided an allowance for shrinkage" (Decision at 54075) is no answer to the agency's failure to account for component losses in the regulated make allowance. The historical allowance required handlers to account for some shrinkage at the Class III price when milk prices were based on competitive pay prices

that are priced in this manner reflect phantom revenue that, under the formula, must be passed on the producer in real dollars. Any component that has been received and priced, but which produces no product revenue, represents a true cost that must be included in a reasonable manufacturing margin, particularly where the imputed ROI would be substantially reduced or made negative by this omission.

Kraft adopts and incorporates the Comments and Exceptions of Leprino Foods and IDFA/NCI addressing additional details of shrinkage cost issues.

V. THE DECISION FAILS TO ACCOUNT FOR COMPETITION FROM CALIFORNIA AND UNREGULATED PLANTS RECEIVING NONPOOL MILK.

The Decision and its accompanying economic analysis provide little or no practical consideration to the competitive impact of the proposed manufacturing margin regulation between plants receiving federally-regulated milk and other plants operating under state regulation or without price or margin regulation. Indeed, the agency's Economic Analysis focused on projected producer blend price impact, milk production response, and milk in non-manufacturing uses rather than on competitive impact or competitive viability of federal order Class III plants under the recommendation.

(the MW or BFP). Shrinkage as a cost factor in regulated manufacturer margins, first employed in 2000, serves very different economic, legal and regulatory functions.

The Decision did recognize that the market for manufactured products is national in scope. Decision, 54066-67. California's share of U.S. production of products manufactured for the national market represents nearly 50% of NFDM, 28% of butter, over 18% of all cheese and over 2/3 of all products sold under the milk price support program. <ftp://ftp.fsa.usda.gov/public/DAIRY/default.htm>.

In each dairy product category, California's market share has sharply increased over the past decade, displacing market share previously served by plants receiving Class III and Class IV (or III-A) milk priced under the FMMO system.

California's average Class 4b prices (milk used to produce cheese) have historically and consistently been below federal order Class III prices, providing California manufacturers with a competitive edge over federally-regulated handlers.¹¹ While USDA has pressed to reduce manufacturing allowances over the past two years by this proceeding, CDFA moved quickly to increase milk manufacturing allowances late last year, thereby aggravating the competitive imbalance. See, CDFA, Determinations of the Department of Food and Agriculture (Dec. 21, 2001), and accompanying Hearing Panel Report (Dec. 20, 2001), on public hearing held Nov. 29, 2001 (<http://www.cdfa.ca.gov/dairy>).

11 California's competitive edge is one of state policy design, to encourage the construction of manufacturing capacity in California and enhance competitiveness of California manufactured products in markets to the east and in international markets. See, STATEMENT OF DETERMINATION AND ORDER OF THE SECRETARY OF FOOD AND AGRICULTURE REGARDING PROPOSED AMENDMENTS TO THE STABILIZATION AND MARKETING PLANS FOR MARKET MILK FOR THE NORTHERN AND SOUTHERN CALIFORNIA MARKETING AREAS BASED UPON A PUBLIC HEARING HELD ON SEPTEMBER 3, 1997 (October 20, 1997)(rejecting proposals to reduce California's milk manufacturing margins).

The cheese make allowance was increased from 16.9 cents to 17.6 cents per pound. Hearing Panel Report at 21.

The table below applies the new CDFA Class 4b price formula and the recommended USDA Class III formula to regulated nonfat solids (per pound) milk prices, actual and as modified or recommended, for 2001.

	CA 4B SNF			FMMO Class III SNF		
	Actual	Modified	Change ¹	Actual	Modified	Change
Jan-01	0.5435	0.5379	-0.0056	0.6311	0.6611	0.0300
Feb-01	0.5709	0.5653	-0.0056	0.5933	0.6367	0.0433
Mar-01	0.6318	0.6262	-0.0056	0.6367	0.6889	0.0522
Apr-01	0.6064	0.6008	-0.0056	0.6033	0.6711	0.0678
May-01	0.7906	0.7850	-0.0056	0.7389	0.8111	0.0722
Jun-01	0.8219	0.8163	-0.0056	0.8389	0.9111	0.0722
Jul-01	0.8705	0.8649	-0.0056	0.8978	0.9656	0.0678
Aug-01	0.8350	0.8294	-0.0056	0.8644	0.9411	0.0767
Sep-01	0.8166	0.8110	-0.0056	0.8456	0.9311	0.0856
Oct-01	0.7623	0.7567	-0.0056	1.0156	1.0489	0.0333
Nov-01	0.6466	0.6410	-0.0056	0.7178	0.7544	0.0367
Dec-01	0.7082	0.7026	-0.0056	0.7811	0.8133	0.0322
Average	0.7170	0.7114	-0.0056	0.7637	0.8195	0.0558

¹Changes in the California cheese and whey butter make allowances decrease 4b SNF prices by \$0.0056/lb. FMMO Class III SNF prices include all nonfat solids priced by combining the recommended protein price and the recommended other solids price to produce a per pound SNF price for comparison to California Class 4b SNF prices.

The difference of almost 10.8 cents per pound solids (\$ 0.973 per hundredweight skim milk) reveals that the USDA proposal will produce an alarming disadvantage for federally-regulated handlers in raw milk costs and in finished product competitiveness.

It would be unrealistic to speculate that California might, out of eleemosynary concern for interstate commercial unity, adjust its manufacturing

margins to conform to federal policy if USDA's recommendations become final. There are absolutely no legal constraints on California's ability to maintain or expand its competitive edge in manufactured products. The restriction on a state's ability to employ non-conforming milk manufacturing allowances contained in Section 145 of the 1996 Farm Bill expired by its own terms over a year ago. (Federal Agric. Improvement and Reform Act of 1996, Pub. L. 104-127, 110 Stat. 914). And California's entire milk pricing and pooling system uniquely enjoys blanket immunity from the Union-binding limitations of the Commerce Clause and the federal Supremacy Clause of the U.S. Constitution according to recent federal appeals court decisions. See, *Ponderosa Dairy v. Lyons*, 259 F.3rd 1148 (9th Cir. 2001). California's manufacturer-friendly policy can be expected in the future to be consistent with past practices. In these circumstances, USDA cannot pursue a manufacturer unfriendly policy, by reducing regulated Class III margins by nearly 50 cents per hundredweight (Decision at 54086).

VI. THE DECISION FAILS TO ALLOW FOR REGIONAL DIFFERENCES IN COSTS AND MARKETS.

The pricing formula and manufacturing margins recommended by the Decision are based on weighted national average costs of a few selected plants. The decision does not address competitive burdens to plants located in regions where costs, or cost components vary from the weighted national average,

except to speculate that “the cost of manufacturing dairy products may vary slightly by region.” Decision at 54074. The agency’s speculation of “slight” regional cost variation is contrary to record evidence of varying regional costs (e.g. Wellington, Tr. 1485), and may directly contradict RBCS survey data of regional cost differences available to USDA, but withheld from disclosure to interested parties in the hearing record.

Beyond peradventure, in any event, many of the cost components included in the surveys are significantly different from region to region. As observed in Kraft’s post-hearing brief (at 8), regional differences in costs of energy, labor, and fuel are documented in statistics published by the Departments of Energy and Labor. Rapidly-increasing energy costs in the West were the principal reason for increased manufacturing margins in California milk prices, but the West Coast is not alone in high regional energy costs.¹²

Other regional cost differences for cheese makers include but are not limited to factors such as milk composition, seasonality, procurement, competitive premiums, whey processing availability, whey transportation to other processing plants, proximity of whey cream buyers, and weather-related

¹² For 2001, electric costs per kwh at Kraft facilities ranged from 3.5 cents to 50 cents. California facilities, not surprisingly, experienced higher 2001 costs than most locations, at 9 to 11 cents/kwh, but locations in Massachusetts, Texas and Georgia were charged rates higher than California rates. Electric rates at New York locations were almost double the rates charged at Wisconsin locations. This type of evidence illustrates the outdated nature of 1998 cost data upon which the Decision relied, and underscores the need to reopen the record.

plant closings. The conservative margin proposed by the Decision would not allow handlers in some regions to recover costs and a reasonable return on investment. Even with corrections to the Class III formula advocated elsewhere herein, the end result will very likely produce unreasonably low returns to many plants in some regions, and to most plants in others. To the extent that the result transgresses the standards of *Hope Natural Gas*, such plants may be entitled to recover the loss of property value of manufacturing facilities by instituting a Due Process “taking” proceeding.

The Decision may reflect a policy choice that will, by reduced margins in the future, discourage the production or expansion of manufactured products in some regions where costs have been greater or efficiency lower. However, while that policy choice is conceivably possible as a matter of constitutional law, *Permian Basin Area Rate Cases*, 390 U.S. 747 (1968) and; *Shell Oil Co. v. Federal Power Commission*, 520 F.2d 1061 (5th Cir.), cert. den. 426 U.S. 941 (1976), it is an administrative option limited under the federal milk marketing order program by 7 U.S.C. Sec. 608c(5)(G), which prohibits the Secretary from adopting a manufacturing margin that would “in any manner limit” dairy products produced in one region from being marketed in any other region.

Accordingly, the Secretary should reconsider manufacturing margins to allow not only more than 50 % of plants to recover their costs and a reasonable

return on investment, but also to assure that no region is burdened with a margin that will preclude plants from continuing to recover reasonable costs.

VII. THE DECISION IMPEDES MARKETPLACE CORRECTIONS TO CHANGING COMPETITIVE CONDITIONS.

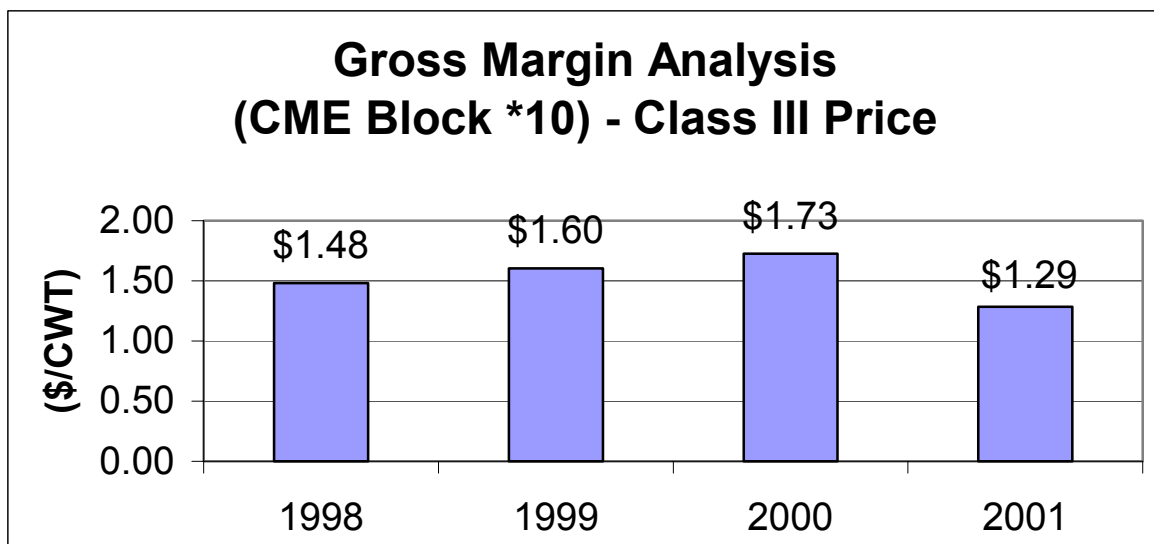
Finally, the recommendations of the Decision, by design, represent a significant change of past agency policy designed to regulate milk prices in a manner that reflects rather than distorts supply and demand for milk and milk products, 64 Fed. Reg. 16025, 16040, 16094-98, (April 2, 1999), and providing a coordinated “system to recognize and resemble the market rather than interfere with the market.” *Id.* at 16109.¹³ At a minimum, USDA’s stated purpose of reducing handler ability to pay unregulated premiums by capturing premiums of the past into future regulated prices (Decision at 54086-87) interferes with manufacturer ability to respond to changes in costs, changes in competition, and changes in supply and demand.

The reduction in manufacturing margins may very well bootstrap prices, as cheesemakers attempt to correct for market or competition in adjusted product prices, only to find their margins squeezed as never before by the

¹³ In the final milk order reform decision, USDA stated: “The importance of using minimum prices that are market-clearing for milk used to make cheese and butter/nonfat dry milk cannot be overstated. The prices for milk used in these products must reflect supply and demand, and must not exceed a level that would require handlers to pay more for milk.” 64 Fed. Reg. at 16094. The Decision herein appears to subordinate the foregoing policy to other administrative concerns.

incorporation of the correction into the regulated price. Correction by adjustment of premiums, as noted, will be constrained to a significant degree by mandating payment of premiums that were at one time voluntary and responsive to supply and demand. Indeed, it appears that the Class III margin reduction adopted by the Interim Final Decision (as adjusted by litigation) has already provided a margin-contracting effect.

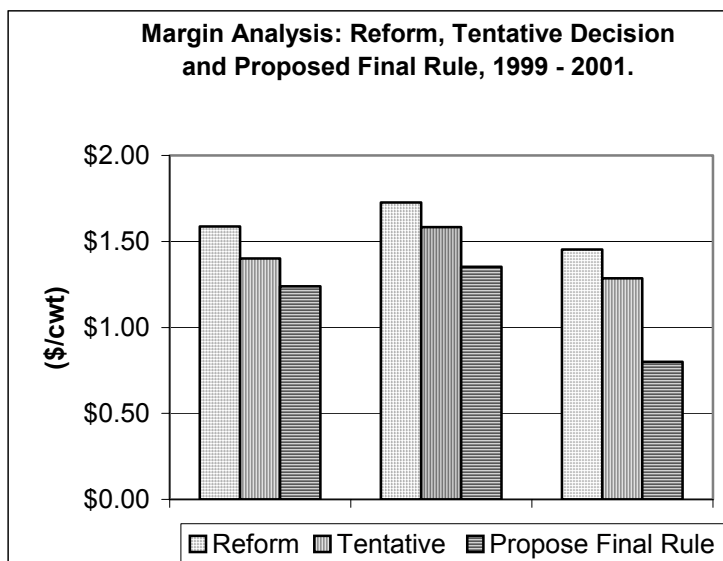
The bar graph below shows actual calculated gross Class III margins per hundredweight milk by simple subtraction the actual regulated Class III price from reported CME cheese prices (10lbs cheese/cwt) for 1998-2001.



CME prices are used for purposes of simplicity and consistency. NASS prices would produce a similar result. The pattern, however, is clear. The marketplace was unconstrained by regulated margins in 1998-1999; and a margin permitting a more flexible response to changes in supply and demand was in place during

2000. Implementation of the Interim Final Decision, however, produced an average margin below the margin purportedly allowed in the formula. The bootstrap pricing or circularity effect has apparently already taken place.

With each successive formula under federal order reform -- the 1999 formula effective in January 2000, the Interim Final formula of 2001, and the Recommended Decision formula -- margins available to manufacturers have been narrowed. The bar graph below visually illustrates this effect by applying the three different per hundredweight Class III formula prices to actual commodity prices for calendar years 1999, 2000, and 2001.



The margin data for the Tentative Decision are those milk prices for 1999, 2000 and 2001 calculated based upon the Tentative Decision AFTER the court ruled against a separate class III butterfat price.

Applied to 2001 data, the Recommended Decision would produce a Class III make allowance of 82 cents/cwt (8.2 ¢/lb. cheese) rather than \$1.65 (16.5 ¢/lb) purportedly included in the formula – a negative net margin (*See also* IDFA/NCI Comments at pp. 32-38). This extraordinary contraction of the manufacturing

margin allowed under regulation is clearly not supported by rationale contained in the Recommended Decision under *Hope Natural Gas* ratemaking standards, by “strict and demanding” rulemaking standards of *Motor Vehicle Manufacturers Association v. State Farm Mutual*, 463 U.S. 28, 48 (1983), or by the substantial record evidence test of 5 U.S.C. § 556(d).

CONCLUSIONS

The defects and omissions of the Recommended Decision, and inadequacy of a hearing record now two years old, simply reflect the fact that both USDA and the dairy industry need time and experience to respond to the rigors of ratemaking standards. After many decades of pricing milk based on competitive milk prices rather than fixed manufacturing margins, it is not surprising that procedural and regulatory adjustments have been awkward at first.

Regulated parties now have notice of factors considered, and of assumptions employed by the agency, that were absent in the Notice of Hearing. USDA now has the opportunity to focus a ratemaking hearing on facts and issues it deems significant, and to affirmatively develop evidence relevant to ratemaking standards. The agency also has a new opportunity to disclose relevant evidence available to it that may be unavailable to individual parties in the past or beyond the resources of small plant operators to produce.

For reasons stated herein, in Kraft's post-hearing brief, and in prior comments of Kraft, in comments of IDFA/CNI, Leprino and other CNI members, the cheese manufacturing allowance should be enlarged to assure recovery of costs and a reasonable return on investment to efficient plants of all sizes and in all regions. To this end, it is requested that the hearing be reopened for additional evidence, updated evidence, and improved notice of material issues and ratemaking standards from the agency.

Respectfully submitted,
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