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Land O'Lakes Dairy Foods

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February 5, 2001

Hearing Clerk
Room 1081, South Building
U.S. Department of Agriculture
Washington, D.C. 20250

Re: Milk in the Northeast and Other Marketing Areas; Tentative Decision
on Proposed Amendments [Docket No. AO-14-A69, et al.: DA-00-03]

Ladies and Gentlemen:

Enclosed for filing are six copies of our Exceptions and Comments on the above-captioned matter.

If there are any questions, please contact me at the address shown on this letterhead. Thank you very much.

Sincerely,

Dennis J. Schad
Director of Marketing & Regulatory Affairs
Land O' Lakes, Inc.

cc: Constance M. Brenner
Marketing Specialist
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Re: Milk in the Northeast and Other Marketing Areas; Tentative Decision
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Ladies and Gentlemen:

Land O' Lakes, Inc. a national dairy cooperative with more than 5,500 members, takes exception to certain decisions contained in the Tentative Decision. Land O'Lakes is joined in these exceptions by Associated Milk Producers Inc., a cooperative with 4,800 members, Agri-Mark, Inc., a cooperative with 1,400 members; Northwest Dairy Association, a cooperative with 775 members; and Maryland-Virginia Milk Producers Association, a cooperative with 1,600 members. Collectively these cooperatives ("Land O'Lakes, et al") market milk in eight Federal Orders

**LAND O'LAKES, et al, OBJECTS TO THE NFDm YIELD FACTOR AS PRESENTED
IN THE TENTATIVE DECISION**

During the informal rulemaking process the Secretary implicitly recognized that the determination of a make allowance formula for Class IV non-fat solids is as much art as it is science. A simple formula where a make allowance is subtracted from a price series and multiplied by a yield factor is inappropriate for Class IV solids. Class IV solids are captured in two end products, non-fat dry milk (NFDm) and buttermilk powder (BMP). Since BMP contains more residual butterfat than NFDm, one expects the yields of the two products to be different. In addition, all witnesses at the hearing testified that there is

a difference in the cost of producing BMP as opposed to producing NFDM. Moreover, since BMP and NFDM are not interchangeable products, each commodity commands a different price in the marketplace.

In spite of the obvious difficulties, the Department in the Tentative Decision set forth a calculation to rationalize a change in the make allowance formula for Class IV non-fat solids. The calculation offered by the Department, rests on three important assumptions about price, cost of production and yields of NFDM and BMP.

Witnesses from Land O'Lakes and IDFA both testified to the relative prices of BMP and NFDM. Land O'Lakes compared Northeast prices and IDFA compared Midwest prices for a recent time series. The Department compared Western prices and used a longer time series. Land O'Lakes and IDFA agreed that the price of BMP is about 75 percent of the price of NFDM, the Department concluded that the price relationship is 80 percent.

There was very little testimony offered at the hearing regarding the cost of production for BMP. Professor Stephenson of Cornell University acknowledged the cost of drying BMP would be "somewhat more" than the cost of drying NFDM. The reason for the increased costs, according to Stephenson, were the costs due to scheduling small lots of BMP, collection, storage and repasteurization of the buttermilk skim.

The Department puts great creditability to the statement from the Agri-Mark witness:

Buttermilk powder make allowance, I'm assuming \$.147, a penny above what it is for nonfat dry milk. Actually, our plant people have said it's probably one to three, so I choose one just to try to say it was - - I didn't want to over-exaggerate the impact of it.

The Department puts great weight on this statement, but fails to take the statement in the full context of the witness' testimony. This particular statement was made while developing a theoretical price construct. He adds his BMP make allowance to the former NFDM make allowance only to illustrate his larger NFDM make allowance model.

In reality, the witness also testified that his cost of NFDM production was \$0.172 per pound, so Agri-Mark's witness is actually testifying that their cost of producing BMP falls between \$0.182 and \$0.202. In the absence of any other empirical evidence offered at the hearing on the cost of producing BMP, the Department assumes too much when it asserts

that one need only add \$0.02 to its new NFDM make allowance to find the cost of producing BMP.

Similarly, the Department relies heavily on a report issued by the California Department of Food and Agriculture, *Butter and Powder Yields*. The Report states that CDFA had been approached by the industry to determine whether the current yield factors for NFDM and butter are appropriate. The Report was issued in 1998. Currently, California uses a multiply by .99 factor for NFDM yield and a multiply by 1.2 for butter. Arithmetically these factors are equivalent to a divide by 1.01 for NFDM and by .833 for butter. Both factors provide a lower cost of milk to a California butter-powder manufacturer than those published in the Tentative Decision.

The Report states plainly that

. . . tracking milk components entering the plant as milk of some intermediate product and exiting the plant as finished products or as plant loss is complex. The procedure used to obtain the yields simplifies plant receiving, processing and packaging activities and the resulting figures should be treated as unrefined estimates of butter and powder yields.

No representatives from CDFA were present at the hearing to explain the Report and one witness, who entered the report as an exhibit and who was cross examined on the inconsistencies of the report, said that the report should stand on its own. Since the release of this report, CDFA has not adjusted its yield factor, nor has that Agency scheduled any hearings to address the issues raised by the report. To the extent that the report can be relied upon by the Department for purposes of this proceeding, it would be most appropriate to use it in ways consistent with the conclusions regarding yields drawn by the CDFA and used in their state order.

At the hearing in this proceeding, the witness from Land O'Lakes offered the only empirical evidence concerning powder yields, and he affirms the criticism made by the Department of his testimony in the Tentative Decision. The testimony would indicate that there is an 81 percent recovery rate of buttermilk solids. Clearly this is in error and confirms the CDFA's point that tracking and accounting for processing, packaging and plant loss is complex.

Despite the error, the point made by the witness at the hearing is still valid. At the point of the powder manufacturing process, after the separation of cream and skim, the powder maker receives approximately one pound of NFDM for each pound of solids in the skim

milk. The solids losses, incurred during the evaporation and drying of the skim milk, are roughly equal to the moisture retained in the powder. The witness from Agri-mark confirmed this relationship of one pound of skim solids equating to one pound of powder, in his testimony. The witness made two other points.

First, the process at this point does not account for the fact that the processor is also paying for a stream of solids-not-fat that is not captured in NFDM, but is captured in BMP. Testimony was offered that the cost of processing BMP is higher, the yield is lower and the sales return of BMP is lower than NFDM.

The second point is that the evidence presented accounts for the solids in the skim and does not account for the losses incurred prior to the separation of the cream and skim. The processor pays for weights and tests at the farmer's bulk tank. Any losses between the producer's component test in the sample vial and the volume in the producer's tank are not accounted for in the evidence presented.

The statement in the Tentative Decision that the orders have always had provisions, which provide an allowance for shrinkage, is misleading. While the orders account for the difference between a plant's ticket weights and test (receipts) and its skim and cream use, the orders do so only to allocate skim and butterfat to its appropriate classification. No credits for losses between a farmer's bulk tank and a Class IV handler's churn and dryer are ever forwarded to a handler. Yield losses by a processor are not addressed through the orders and do represent a cost.

Additionally, the Department states that the RBCS and CDFA surveys allocate plant costs to actual finished product and concludes that this process should take shrinkage in account. However, it is unclear how this process fully accounts for shrinkage. Dividing manufacturing costs by units produced provides the manufacturing cost per unit. And if, shrinkage results in fewer units, then the cost per unit increases. However, the issue of yield goes beyond the allocation of manufacturing costs and includes the difference between the amount and cost of raw material (milk) paid for by the processor and the amount of finished product recovered. The RBCS and CDFA surveys do not fully account for losses in product incurred between farm and warehouse.

THE SECRETARY SHOULD AMMEND THE TENATIVE DECISION AND RESTORE THE NON-FAT DRY MILK YIELD AT DIVIDE BY 1.02

Non-fat dry milk is unique among the other Class III and Class IV products. Cheese and butter makers have the opportunity to change the form of the product (mozzarella) or the serving size (quarter-pound sticks) in order to capture value above the NASS reported Class III and IV commodities. With the exception of very small markets in high heat or whole milk powders, there is no opportunity for a powder-maker to move beyond a commodity product. And commodity products are the market clearing products.

On page 174 of the Final Decision that adopted the current orders (March 1999), the Secretary recognized the importance of market clearing function and wrote:

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 for pay more for milk than needed to clear the market and make a profit.

The Tentative Decision increases the cost of Class IV by \$0.13 per hundredweight, with all of the increase borne by NFDM. This is a large increase, which will be shouldered primarily by the cooperatives that balance the market with their butter powder plants.

The Department justifies its changes to the Class IV formula based on assumptions concerning price, cost and yield. Land O'Lakes and IDFA offered recent price comparisons of BMP and NFDM, which showed that BMP was priced at 75 percent of the NFDM price. Without disputing the IDFA and Land O'Lakes' price series, the Department used a different series that reported an 80 percent price relationship. Had the Department used the industry price series, it would have rounded down, instead of up, its number and thus, justified a divide by 1.01 yield.

There was no evidence offered on the cost of producing BMP, save an off hand remark by a single witness. That witness offered no detail to his assertion and the Department questioned no other witnesses, representing butter powder manufacturers concerning the cost of producing BMP. While AMPI's NFDM testimony concerning NFDM costs was disallowed due the lack of volume numbers, Agri-Mark's remark stands, notwithstanding the lack of evidence of Agri-Mark's impact on the BMP market.

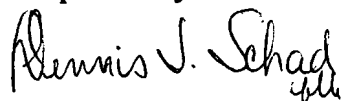
On the question of yields, the Department relies on a paper, *Butter and Powder Yields*, published by CDFA. No witness was offered to answer questions, concerning the report's assumptions or conclusions. In absence of a witness from California on the record to explain, endorse and be questioned concerning the paper's findings, the inaction of

California to act on the report's conclusions in two years may speak volumes. We don't know how California regulators view this report; however, the Department uses the report as the benchmark measurement of yield recovery for the Federal orders.

The only empirical evidence concerning NFDM and BMP yields, offered at the hearing, showed there is a one to one recovery of non-fat solids in skim milk to NFDM produced. In addition, there is another stream of solids that is recovered as BMP. Priced as solids recovered as NFDM, this stream of buttermilk solids command a lower price in the marketplace and cost more to recover. Additionally, the witness from Agri-Mark testified he believed the BMP yield was less than the yield of BMP. Moreover, the skim non-fat solids to NFDM relationship does not account for yield losses from the farm to the raw milk separator.

Land O' Lakes, et al respectfully believes that the hearing record in this proceeding is inadequate to support change of the yield factor in the Class IV solids formula. We note that the RBCS study reflects 1998 costs and since that time there has been a threefold increase in energy prices. Since the manufacture of NFDM is energy sensitive, we anticipate a request from industry to review the Class IV make allowance. At such time, the Department can request additional data on NFDM and BMP yields and determine formula values from a full record. Until that time, the Final Rule yield factor for NFDM should be restored.

Respectfully Submitted,



Dennis J. Schad

Director of Marketing & Regulatory Affairs
Land O' Lakes, Inc.