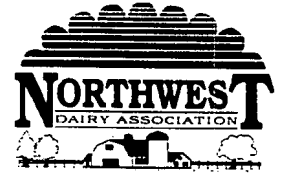


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February 5, 2001

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:

The following Exceptions and Comments are respectfully submitted in response to the Tentative Decision identified above. They are filed on behalf of Northwest Dairy Association ("NDA"), a cooperative association representing approximately 775 producers whose milk is pooled on the Pacific Northwest Federal Order (Order 124) and the Western Federal Order (Order 135).

The comments are also submitted on behalf of WestFarm Foods, which is the subsidiary operating company of NDA. WestFarm Foods operates pool plants that are fully regulated by both Orders 124 and 135. In addition, WestFarm Foods operates a major cheese plant at Sunnyside, WA and three drying plants (at Caldwell, ID; Chehalis, WA; and Lynden, WA). The Caldwell plant can also make cheese, although it has not done so since last summer.

NDA participated in the hearing last spring on this matter, and submitted a post-hearing brief. At this time, we respectfully take formal exception to the following:

- The decision to disconnect the Class III butterfat price from the butter market;
- The decision to establish the conversion cost factor ("make allowance") for whey (in the Class III formula) at the same level as for NFDM; and
- The decision to revise the NFDM yield factor in the Class IV formula.

NDA and WestFarm Foods have formally joined in Exceptions and Comments filed in this proceeding by two other organizations:

1. The Comments of National All-Jersey expresses our concerns about the decision to realign Class III butterfat pricing.
2. The Comments of Land O'Lakes *et. al.* expresses our concerns about the change in the Class IV formula's "yield factor".

We will comment further, below, on both subjects.

**EXCEPTION #1: THE DECISION TO DISCONNECT THE CLASS III BUTTERFAT VALUE FROM THE BUTTER MARKET WAS UNSOUND.**

As noted above, we endorse the comments made by National All Jersey (joined by dozens of others from the industry) asking that this change be rescinded for various policy reasons. We have seen drafts of similar comments that are being made by the International Dairy Foods Association, of which WestFarm Foods is a member, and also by the National Milk Producers Federation (NMPF), of which NDA is a member; we endorse the thrust of those organizations' comments on this subject, as well.

In addition to those comments, we would like to emphasize the following two points, offered from the standpoint of dairy farmers.

1. Because the Class III component values are used to establish pool distributions, and are used to pay producers across the country, it is important to note that the majority of the producer milk under the national order program does NOT go to Class III but instead goes primarily to other classes of use. Order 124 is an illustration of that. Just as it is appropriate that the Class I, II, and IV charges send proper price signals to plants for butterfat (BF), it is similarly appropriate that producers for those classes of use should be sent price signals reflecting the butter market.
2. Producers can easily follow the butter market, and they do so in making feeding decisions designed to impact the BF yields of their herds. When the butter market is high, many will alter their feeding to achieve a higher BF level. To change this historic price relationship, and replace it with a blend of BF values, is a change that was neither sought at the hearing nor one which will benefit producers.

We respectfully submit that the best price signal to send dairy farmers with respect to butterfat is the butter market.

We note that this portion of the Tentative Decision was enjoined by the District Court in Washington, D.C. Had it not been for that, and had that concept found its way into the final rule, it is likely that the industry would have requested a new hearing to bring before the department evidence of disorderly marketing conditions resulting from the change. One of the Department's options at this point may be to reopen the hearing for additional evidence regarding this aspect of the proceeding. We urge USDA not to do so, and to work within the structure of the "old formula" as mandated by the Court.

**EXCEPTION #2: THE DECISION TO ESTABLISH THE CONVERSION COST ALLOWANCE FOR WHEY AT THE SAME LEVEL AS FOR NFDM IS NOT SUPPORTED BY THE RECORD EVIDENCE.**

The Department seems to justify that decision by the lack of evidence:

*For the calculation of the Class III "other nonfat solids" price, neither the California nor RBCS studies included information on the cost of making dry whey, and a survey done for this proceeding under the auspices of IDFA was not considered sufficiently reliable for use in establishing a make allowance. Consequently, the "other solids" make allowance should continue to be the same as that used for nonfat dry milk.*

However, this reasoning overlooks substantial testimony, all of which demonstrated that whey is more expensive to dry than NFDM. If there is evidence sufficient to adjust the NFDM price from 13.7 to 14.0 cents per pound, then surely some adjustment can be made to the whey conversion cost allowance, to reflect the higher costs testified to by (what the Tentative Decision described as) "Most witnesses who testified about the cost of drying whey".

If this reflects "most" of the testimony, why was it not followed? We are aware of no such evidence that would contradict what "most" of the witnesses testified to and would justify a whey conversion cost allowance as low as the 14 cents used in the Tentative Decision.

As noted in the Tentative Decision, a highly qualified witness from Leprino testified that it costs some 2.6 cents/lb more to dry a pound of whey than NFDM. The indisputable fact is that raw whey has more water to be removed in the evaporation and drying process than does skim milk used to produce NFDM -- and that requires more energy. He also testified that whey must be dried in a "double effect" drier (two drying chambers), whereas NFDM can be dried in a more energy-efficient, "single effect" chamber.

Similarly, a Kraft witness testified to a 2.5 cent difference – very similar to the Leprino testimony. If we read the Tentative Decision correctly, the Kraft testimony was dismissed as atypical: “*Although Kraft described its Tulare plant as large and efficient, it also represents a recent capital investment, meaning that depreciation costs are likely higher than average.*” NDA would take especially strong exception to that statement, if it reflects any reasoning that would suggest that high depreciation costs should not be considered. After all, the typical justification for any new capital investment is to lower the investor’s operating costs, more than enough to offset the cost of the capital investment (depreciation). If Federal Orders are to use the lower operating costs of a new facility, but don’t consider the higher depreciation that buys that efficiency, the Department will be consigning the industry to old, inefficient plants. It’s the total cost structure that must be considered (variable costs plus depreciation).

New plants simply must be encouraged when establishing Federal Order conversion cost allowances. The new Kraft plant should be MORE efficient, being new; it should be the BEST indicator of what a low conversion cost is (as long as it is operating at relatively near its design capacity). It is true that an older plant often will show the accountants a lower operating cost, because its depreciation is based on 1985 or 1975 dollars. But those are the numbers that should be tossed out, not the more realistic figures that reflect replacement costs. If USDA establishes cost allowances based on out of date costs, new whey facilities will never get built, as the NDA-Tillamook testimony and the Agri-Mark testimony indicated. Federal Orders would benefit neither producers nor cooperatives if they establish such low allowances for conversion costs that producers will not be able to market their milk.

As noted above, the Leprino and Kraft testimony both suggested the whey cost allowance should be 2.5 cents more than the NFDM allowance of 14.0, or 16.5 cents/lb. NMPF, which proposed the 14.0 level adopted by the Department for NFDM, also proposed an additional penny for whey (or 15.0 cents/lb) to reflect the additional cost of removing water from whey. It should also be noted that there was substantial testimony supporting an NFDM allowance greater than 14.0, suggesting that even a 15.0 or 16.5 cent figure for whey may be conservative.

We acknowledge that DFA’s evidence suggested only 14.8 cents, and IDFA’s evidence suggested 15.9. Those figures are slightly lower than the 16 cents that NDA feels is justified by the record evidence, but the fact remains: there was simply no evidence supporting the 14.0 figure used in the Tentative Decision.

NDA respectfully suggests that it was erroneous not to apply this testimony, and to establish a conversion cost allowance for the whey component of the Class III formula in the range of 16 cents/lb.

**EXCEPTION #3: THE DECISION TO REVISE THE CLASS IV SOLIDS YIELD FORMULA IS NOT SUPPORTED BY THE RECORD EVIDENCE.**

The Exceptions and Comments suggested by Land O'Lakes *et. al.*, explain why the evidence relied on by the Department in the Tentative Decision was misplaced, and why the Final Decision in this proceeding should revert back to the yield formula used in Federal Orders since January of last year. NDA endorses that recommendation, but offers these additional comments.

One of the points made in the comments by Land O'Lakes *et. al.* is that USDA should not rely upon the study of "Butter and Powder Yields" introduced into evidence (Exhibits 26 and 31) from the California Department of Food and Agriculture (CDFA), without someone from the state being available for cross-examination to explain this document. To illustrate that point, NDA respectfully suggests that the Tentative Decision reflects a misunderstanding of one of the tables in that document, which is reproduced below, along with the paragraph that precedes it:

Among the five plants included in the calculation, the yield for NFDM ranged from 0.9309 to 0.9815 and the yield for BMP ranged from 0.0406 to 0.0749 (Table 2). Using an average weighted by production volume, the five plants obtained 0.9736 pounds of NFDM and 0.0521 pounds of BMP from 1 pound of SNF

Table 2. Powder, NDM and BMP Yields for Select California Processing Plants <sup>1, 2, 3, 4</sup>

	<u>Powder Yield</u>	<u>NFDM Yield</u>	<u>BMP Yield</u>
<i>Number of Plants</i>	5	5	5
<i>Weighted Average</i>	1.0252	0.9736	.0521
<i>Low</i>	1.0111	0.9309	.0406
<i>High</i>	1.0406	0.9815	.0749

<sup>1</sup> "Yield" refers to the amount of product obtained from a unit of fat or SNF.  
<sup>2</sup> "Powder Yield" is the sum of the individual plant nonfat dry milk and buttermilk powder yields.  
<sup>3</sup> "NFDM" = nonfat dry milk.  
<sup>4</sup> "BMP" = buttermilk powder

The key point is that the Powder Yield of 1.0406 is the highest of the five plants, and the BMP yield of .0749 is the highest of the five, but there is no reason to believe that they are the same plant. Indeed, the text quoted above clearly indicates those numbers are the (separate) extremes of the two ranges. Note that the CDFAs survey of plant manufacturing costs (also relied upon in the Tentative Decision) also follows this format (the four vertical cost breakdowns do not

represent the same plants in each column). The Table reproduced above is a bit confusing, in that the two numbers (1.0406 and .0749) appear on the same line.

Regrettably, it is clear that the Tentative Decision was based on the incorrect assumption that the two numbers come from the plant. This is seen in the discussion of “Yield (Nonfat Solids)” in Section 3.b of the Findings and Conclusions, in the paragraph relating to the Department’s reliance on the CDFA study’s weighted average yield of 1.0252:

*“The California data indicate a weighted average powder yield of 1.0252 pounds of NFDM and BMP from 1 pound of nonfat solids. One witness discounted this data by observing that the “high” California yield was reported as 1.0406, which would represent a higher-than-allowable moisture content. This number is undoubtedly influenced by the “high” reported BMP yield of .0749.”*

In fact, it is “undoubtedly” not related. It is evident that the Department incorrectly interpreted Table 2 of the CDFA study, and was in error to discount the witness referred to (believed by the author of these Comments to be himself). In fact, there is no clear relationship between the 1.0406 and .0749 numbers (the odds are one in five they come from different plants). Neither influences the other.

Indeed, the .0749 BMP number suggests the opposite conclusion than appears to have been drawn by the Department in the paragraph just quoted. The Department seems to suggest that the BMP number it characterizes as “high” somehow offsets the 1.0406 (there is no other “rebuttal” of the witnesses’ view that the 1.0406 is inappropriate, and the Tentative Decision proceeds to ignore the witness as if .0749 number responds to the problem of unacceptably high moisture in one of the NFDM yields in the survey). However, an unusually high BMP number would not offset the high moisture level in NFDM in the survey – both a high BMP and the high-moisture NFDM would tend to increase the weighted average that the witness had warned was skewed high.

Unfortunately, it is clear that the Department did rely on a 1.0252 yield factor that includes powder with a higher than allowable moisture content. That would be extremely inappropriate for purposes of the Federal Order program, just as it would be inappropriate to base the butterfat formula on the assumption that the plant puts less than 80% BF into the butter or to base the cheese formula on the assumption that an unacceptably high moisture content is contained in the final product. We also note that doing so would be even more inappropriate when the USDA, on behalf of the Commodity Credit Corporation (CCC), then uses the Federal Order conversion cost allowances – they would come up with a formula for the cost of making a product the CCC won’t accept!

The foregoing illustrates the importance of the observation by Land O'Lakes *et. al.* to the effect that the CDFA document can not be overly relied upon, inasmuch as there was no competent witness from the CDFA able to testify to it. NDA suggests a comparison with the Department's conclusion about the conversion cost evidence, that "*less weight must be given the NCI study*" for three reasons. One was that "*No one who actually conducted the survey was made available to testify*". That was contrasted in the Tentative Decision with the CDFA conversion cost study – no one from CDFA testified about it, however the procedure manual was made available to the participants in this proceeding. We note that the paper on "Butter and Powder Yields" was not accompanied by any such manual or similar evidence. NDA therefore respectfully submits that the CDFA study is not sufficient evidence to be used in making a major change in the Class IV formula, in the absence of other supporting evidence.

Clearly, the CDFA study on "Butter and Powder Yields" is limited in the use to which it can be made. It includes powder with moisture levels that would not meet the CCC's standards. That skews the 1.0252 "weighted average" yield factor, which is in turn "less reliable" than it would be if that powder could have been removed from the calculation through additional testimony at the hearing. The remaining aspects of the study are not necessarily incompetent evidence, but the Department's reliance on the 1.0252 yield figure in this proceeding is "clearly erroneous".

The derivation of the new NFDM yield factor (to which NDA takes exception) explicitly relies upon the 1996 CDFA study just discussed. That derivation involves four steps (identified as "a." through "d."). Step "c." seems to start by assuming a yield of 1.03 lbs of powder in a cwt of milk containing 8.62 percent nonfat solids. The derivation of that 1.03 assumption is not clear, but we fear it is a rounding up of the 1.0252 number from the CDFA study that (we shall presently demonstrate) reflects something else. By our reasoning, Step "c." suggests (8.62 times 1.03) 8.786 lbs of powder out of that cwt of 8.62 percent milk. Somehow, this is then translated into .54 pounds of BMP and .976 pounds of NFDM, or only 1.03 lbs. This calculation is confusing, and to us it is nonsensical. There may be an underlying calculation not shown, demonstrating the ratio between NFDM and BMP in milk containing 8.62 percent SNF; but that is unclear. We respectfully suggest it is insufficient reasoning to be used in rule making.

In fact, we suspect that the goal was to align with the CDFA yields in Table 2, however those are (per footnote 1) unrelated to the SNF content of the raw milk – rather, the yields reflect the "amount of product obtained from a unit of fat or SNF". That attempted alignment is done perhaps more directly in Step "d." wherein the "low" 1.01 yield from the CDFA study is referenced. The problem

there is that if one assumes a unit (pound) of SNF is reduced by the plant loss that is clearly adopted in the Tentative Decision (the CDFA study's figure of 2.13%), the one pound unit is reduced to .9787 pounds of SNF. Then, adding back 3% moisture would mean only 1.008 lbs of resulting powder produced. Step "d.", however, assumes .053 lbs of BMP and .957 lbs of NFDM. The total (1.010) is .002 too high. This could be rationalized using .955 lbs of NFDM instead of .957.

The Tentative Decision then proceeds with a calculation. The NFDM value is computed (using .957 lbs) at \$0.85173. However, if this is done with the .955 figure which would logically flow from the other assumptions in the model, that value is only \$0.84995 – a difference of \$0.0018. If that adjustment is made in the calculation that follows in the Tentative Decision, we see a "more precise" value for NFDM and BMP of \$.8851 instead of \$.8869. That is then compared to, and assumed to equal, a figure of \$.8900 derived from the proposed yield factor of 1.00. But in fact, the result is off by (.8900 divided by .8851 = 1.0055) .5%. If we follow the Department's thinking, the yield factor (divisor) should be 1.005 instead of the present 1.02 or the proposed 1.00.

Now, if we revisit the assumed 80% ratio between BMP prices and NFDM prices, and assume 75% rather than 80% following the logic of the comments by Land O'Lakes *et. al.*, then the Department's calculation (with our adjustment above) becomes:

BMP:	$(\$1.03 * .75) - .16 = \$0.6125;$	$\$0.6125 * .053 = \$0.03246$	
NFDM:	$\$1.03 - \$0.14 = \$0.89;$	$\$0.89 * .955 =$	<u>0.84995</u>
Total:			\$0.88241

Following this logic, the comparison with the \$.89 which is derived from a 1.00 yield factor is off by (.8900 divided by .88241 = 1.0086) or .86%. That would imply a divisor of 1.01 – perhaps not surprisingly, that would line up with the California formula's .99 multiplier! Inasmuch as the CDFA prepared the study relied upon by USDA in this proceeding, and inasmuch as they use a .99 multiplier, a corresponding 1.01 divisor would be an entirely consistent position for USDA to adopt in the future.

To summarize, NDA submits the following:

- The Department must issue a Final Decision which clarifies the reasoning reviewed above;
- The Final Decision should not rely on a yield factor of 1.0252 from the California study, because of the inappropriate moisture content of the "high" NFDM included in the calculation;

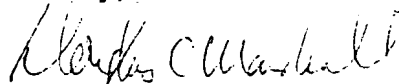


- There is not sufficient evidence in the hearing record to support a change in the NFDM yield factor in the Final Decision, so NDA takes exception to any change; the current 1.02 yield factor should remain in place pending a new hearing (as suggested by Land O'Lakes *et. al.*); and
- If the Department nonetheless proceeds to implement a change in the Final Decision, a yield factor (divisor) of 1.01 should be adopted.

Conclusion: For the reasons described in the foregoing, NDA and WestFarm Foods respectfully request that the Final Decision be issued with the Class III formula as mandated by the District Court decision but with a higher conversion cost allowance for whey (16 cents); and issued with the Class IV formula as proposed in the Tentative Decision, but reinstating the yield formula that was in the decision that went into effect in January of 2000.

We thank the Department for considering our views.

Sincerely,



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