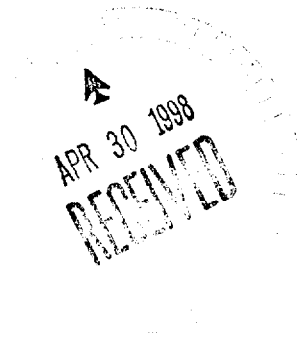# DAIRY INSTITUTE

April 29, 1998

Mr. Richard M. McKee
Deputy Administrator, Dairy Programs
USDA / AMS
Room 2968, South Building
P.O. Box 96456
Washington, DC 20090-6456

Dear Mr. McKee:

Enclosed you will find two copies of the comments of Dairy Institute of California on the proposed rule for federal milk marketing order reform, docket number DA-97-12. We hope you will find these comments helpful in preparing the final rule. If you or any of your staff have questions regarding any of the issues we have raised, please do not hesitate to contact me.

Sincerely yours,

William A. Schiek
Economist

Enclosures

To the Attention of:

United States Department of Agriculture
Agricultural Marketing Service
Dairy Division

In Reference to:

Milk in the New England and Other Marketing Areas,
Docket No. DA-97-12

**Comments of
Dairy Institute of California
In Response To USDA's Proposed Rule for
Federal Milk Marketing Order Reform**

William A. Schiek, Economist
Dairy Institute of California
1127 11th Street, Suite 718
Sacramento, CA 95814
(916) 441-6921

April 30, 1998

The following comments are submitted by Dairy Institute of California (Dairy Institute) with respect to the proposed rule on federal milk marketing order reform issued January 21, 1998. Federal order reform was mandated by the Federal Agricultural Improvement and Reform Act (FAIR Act) of 1996. Dairy Institute's comments address the following topics related to the proposed rule:

Order Consolidation

End-Product Pricing for Determining Manufacturing Milk Values

Class IV, III and Class II Price Formulas and Price levels

The Class I Price Mover

Class I Differentials

Product Classification

Shrinkage

Identical Provisions

Dairy Institute is a trade association representing 40 California milk processors and dairy product manufacturers. Member companies account for approximately 80 percent of the volume of fluid milk, cultured and frozen products, and hard cheese produced in California. The Institute's activities include representing members with respect to both state and federal legislative and regulatory issues, member education and training programs, and dissemination of timely market information and analysis.

The proposed rule contains provisions that are considerably different from the orders of the past, particularly with regard to the determination of prices for various uses of milk. Despite the fact that California is currently regulated under a state milk marketing order and not the

federal system, Dairy Institute's membership has a valid economic interest in the federal order reform process because:

—   The competitive position of California processors is affected by the prices paid by processors operating in federal order markets, and

—   Several California producer groups have petitioned for promulgation of a California federal milk marketing order, raising the possibility that California processors will be regulated under the federal milk marketing order system in the future.

The impact of federal order pricing on California is even more direct than one might think. The state has a provision in statute governing the regulation of milk marketing which states that Class 1 pricing levels set by the California Department of Food and Agriculture (CDFA) must take into account the prices in surrounding markets and be in reasonable alignment with them. Therefore, changes in federal order price levels resulting from the reform process will most certainly impact the prices paid by California processors for raw milk.

We also note that several California producer organizations: California Dairy Campaign, Milk Producers Council, Cal-West Dairymen, Security Milk Producers, and the National Farmers Organization, have jointly submitted a petition requesting that a federal milk order be established in California. While these organizations by no means represent a majority of California milk producers, their petition is indicative of some producer interest in joining the federal system. The larger portion of California producers has yet to decide on the issue of whether to seek a California federal order, but the possibility that California could be regulated under a federal order in the future is a real one, nonetheless. These issues compel us to comment on the proposed rule, focusing specifically on issues that are of concern to California processors, particularly if California were to be subject to federal order regulation in the future. The paragraphs that follow contain our comments on specific portions of the proposed rule, as outlined previously.

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Order consolidation

Most of the order consolidations do not have a direct impact on California. The existing orders that regulate processors who compete with California processors include the Pacific Northwest, Great Basin, and Central Arizona orders. The movement of Las Vegas into a combined order with Arizona, eliminates competitive distortions caused by the Las Vegas raw milk price levels and is therefore supported by Dairy Institute.

The Class 1 price in Las Vegas is currently equal to the Great Basin Order Class I price in Salt Lake City less 30 cents per hundredweight. Las Vegas is geographically closer to Southern California markets than it is to Salt Lake City. The distance from Las Vegas to the heavily populated areas east of Los Angeles is only about 230 miles. When prices in Las Vegas are below Southern California prices by more than 70 cents per hundredweight, raw milk shipments are cost competitive with California milk, particularly milk from the South Valley (Tulare County), which is the reserve supply for Southern California. At times, substantial quantities of milk from outside California have entered the state and disrupted usual supply patterns when prices have been misaligned. Attachment 1 to these comments shows the price relationship between Las Vegas and Southern California. This minimum price misalignment is often compounded by the higher over-order surcharges for Class 1 milk in Southern California as compared with Las Vegas. Combining Las Vegas with the Arizona order, which has a higher base Class 1 differential, should reduce incentives for milk to flow from Las Vegas into the California market and provide for better overall price alignment, and more orderly marketing (less disruption of traditional fluid supply patterns) within the region.

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End-Product Pricing for Determining Manufacturing Milk Values

Dairy Institute supports the concept of end product pricing for milk component values, which has been used in California since 1969 for manufacturing milk classes. The California's dairy industry's experience with end product pricing puts California processors in a position to make well-informed observations regarding the requirements for the proper operation of this type of pricing system. The end-product-pricing concept, which reveals an appropriate raw milk value by taking a product price, subtracting a make allowance, and then multiplying the result by a product yield, works well, provided the following conditions are met:

1. The manufacturing costs used to construct the make (manufacturing) allowance are accurate, representative, and updated on a frequent basis to account for changes in plant efficiency, scale, and technology.

2. The yield factors used are representative of those actually obtained by plants when converting raw milk of *average* composition into manufactured products.

3. The product price series used reflects current market conditions, as well as the competitive regional price surface for manufactured products. That is, in each region, the end product prices should be reflective of the prices that manufacturers in that region could actually obtain. When pricing formulas are based on product prices that are higher than those that can be obtained within the region, raw milk for that class of milk will be overvalued and manufacturers will be at a competitive disadvantage relative to their counterparts in other regions.

The product pricing formulas contained in the proposed rule, in some cases, violate all three of these conditions, and therefore need to be changed. Specifically, the proposed manufacturing allowances are too low in every case, resulting in overvalued raw milk prices. Regional differences in the value of cheese, butter, and powder are not accounted for, putting manufacturers in regions which have lower competitive product values at a competitive disadvantage with respect to raw milk cost. Product yield assumptions, with respect to nonfat dry milk powder and whey, are unrealistically high and are not representative of yields attainable by most plants. What is particularly disturbing about the collective impact of the

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proposed formula coefficients is that, in almost every case, the effect is to increase prices. It appears to the observer that price enhancement was the goal of the Department in establishing these formulas. In setting regulated minimum milk prices, the greatest danger is in setting prices too high. When prices are set too high, the result is artificially stimulated milk production, which reduces (in some cases permanently) dairy product consumption. The potential then exists for real "mailbox" producer prices to fall below the regulated minimum prices as cooperatives are forced to dispose of surplus milk in the lowest valued uses, sending commodity prices plunging. Any revenue enhancement for producers is thus short-lived and disorderly market conditions arise as the industry attempts to deal with surplus milk. Proprietary processors and manufacturers are especially disadvantaged as they are forced to pay a regulated minimum milk price that does not sufficiently cover their costs nor generate adequate returns. As more milk is sold through cooperatives and milk "disposal" costs are reblended to producers, milk revenues continue to fall and cooperatives become the only form of business that can successfully compete because they are not "locked in" to overpaying for raw milk, as would be the case for proprietary processors.

If regulated prices are set too low to bring forth a sufficient supply of milk, market forces will quickly signal this to the industry through such market-oriented changes as higher commodity prices and the development of incentive payments or competitive price premiums paid by processors to producers. Thus, regulated prices should undergird the marketplace, rather than being the prices at which nearly all transactions take place, allowing market forces to bring forth higher prices when they are needed.

With respect to make allowances, the procedures used by the California Department of Food and Agriculture (CDFA) for determining manufacturing costs are recommended as a model for the federal orders. The proposed use of NASS surveys is not inappropriate, although

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such series will lag price changes at the commodity exchanges where dairy product prices are "discovered." The NASS price surveys should be audited and mandatory in order to preserve the integrity of the pricing system. The NASS surveys should also be constructed to obtain both national and regional price averages to accurately reflect the differences in location value of manufactured milk products.

Class IV, III and Class II Price Formulas and Price levels

Dairy Institute's members are advocating that many of the proposed coefficients in the formulas for manufactured product classes be changed. The specific issues related to each of the class price formulas are discussed below.

Class IV – milkfat

Under the proposed rule, the value for milkfat which will be used in Class IV, III ,and II will be determined by a proposed formula which uses the NASS Grade AA butter price less a make allowance of 7.9 cents per pound divided by a yield factor of 0.82. While the yield factor appears to be accurate, the proposed make allowance is too low for all but a few extremely large efficient plants. The genesis of this number (90% of the California make allowance) appears to have been arbitrary. The reference to university cost studies that rely on data from 1988 (specifically, Stephenson and Novakovic (1990)) should not be used as the basis for regulating 21st century dairy policy. Industry costs, structure, and technology have all changed substantially since this study was completed. While the merits of this cost study are not debated here, the information is simply too old to be relevant for establishing dairy policy in 1998. A comprehensive cost survey should be undertaken as the basis for the manufacturing allowances. Until such a survey is complete, the weighted average of California butter

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manufacturing costs as published by CDFA, or an average of data from the USDA Rural Cooperative Business Survey and CDFA data could be used. These data suggest a butter make allowance in the range of 10 to 12 cents per pound would be more appropriate.

The price series used should also reflect regional difference in the location value of manufactured product. Data from CDFA for 1996 and 1997 demonstrate that California wholesale bulk butter prices average about 5 cents per pound less than Midwestern butter prices (see Attachment 2). This amount represents the approximate cost to transport butter from the West Coast to Chicago. The product formulas in the different regions should reflect the appropriate regional end product price.

We are familiar with the argument that these regional price differences are generated solely by the differences in the raw milk price paid by processors. Put another way, some argue that the regional manufactured product price surface is primarily supply driven in that if a processor pays less for raw milk, it will be able to (and will automatically) charge customers less for finished product. This is simply not the case. It is a well-established economic principle that regional prices for a particular commodity will differ by at most the transportation cost between the regions. When prices differ by less than transportation costs, no interregional movement of the product will occur. If prices between regions were to differ by more that transportation costs, buyers in the higher-priced market would seek to purchase all the product they could from processors in the lower-priced market, bidding up the price to the point where the regional price difference is just equal to the cost of transporting the product between regions. Of course, exceptions to this pricing "rule" can exist for short periods (1-3 months) due to contractual obligations which may lock-in a buyer to a particular supplier for some limited time, but price differences greater than transportation costs cannot be sustained.

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Hence, the price surface is determined by supply, demand, and transportation cost, with transportation cost being the limiting factor on price differences between regions. It is therefore appropriate to recognize regional end product price differences in the product pricing formulas, and to apply the appropriate regional price in the appropriate market. Another valid approach would be to use the lowest regional end product price as the formula price in all markets and allow market forces to drive effective raw milk prices higher in the higher-valued product markets. The validity of different regional manufacturing milk values has been advanced in some of the same Cornell University work cited by USDA as justification for the Class I differential options (see Pratt et. al. *U.S. Dairy Sector Simulator-A Spatially Disaggregated Model of the U.S. Dairy Industry*, Cornell University Department of Agricultural, Resource, and Managerial Economics Staff Paper 96-06 (November 1996)). If USDA accepts the notion that Class I milk has different values based on its location, then it must also accept that manufacturing milk, likewise, has different values based on its location.

Class IV -- solids not fat

Under the proposed rule, the Class IV solids-not-fat (SNF) price will equal the NASS Nonfat Dry Milk (NFDM) price less a powder make allowance of 12.5 cents per pound divided by a yield factor of 0.96. The make allowance proposed by the Department is again too low. Even California, which has many of the largest and most efficient powder plants in the country has a weighted average manufacturing cost that is higher than the proposed make allowance of 12.5 cents. California and USDA Rural Cooperative Business Survey data would indicate that a powder make in the range of 13.5 to 14 cents would be more realistic and appropriate for use in the Class IV formula.

The nonfat milk powder yield factor employed in the proposed rule is unrealistic and should be increased from the proposed 0.96 to a value of at least 1.01, which is the yield factor used in California, where many of the largest and most efficient plants are located. IDFA and NMPF are proposing a yield of 1.02 as being more realistic for the nation as a whole. Dairy Institute would support a yield of 1.02 as well. The yield factor of 0.96 seems to assume a maximum conceivable moisture content in the powder and does not allow for any product losses in manufacturing. These assumptions are highly unrealistic and cannot be defended. Their primary effect would be to enhance prices for the raw milk used to make a product that is clearly not in short supply.

The federal order Class IV SNF prices must reflect the difference in location value of NFDM powder. The powder transportation costs are lower than those for butter and cheese, but they are not negligible when large distances are involved. The current Class III-A pricing in federal orders reflects difference in regional values and the new Class IV pricing should as well. Western III-A prices are 14 cents per hundredweight lower than Midwest III-A prices, and as much as 28 cents per hundredweight lower than Eastern III-A prices. These translate into powder price differences of 1.6 cents per pound between the West and the Midwest, and a little over 3 cents per pound between the West and the East. Attachment 3 shows the Western and Central powder prices reported by *Dairy Market News* for 1996 and 1997. The average powder price difference for those two years was about 3 cents per pound.

Class III - fat

Under the proposed rule, the Class III fat component price will be set equal to the Class IV fat price. Hence, the comments made by Dairy Institute on Class IV fat price apply to Class III fat pricing and will not be repeated here.

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Class III - protein

The formula for protein component pricing under the proposed rule is as follows:

protein price =   (NASS 40lb. block price - 12.7 cents)*1.32

+[(NASS 40lb. block price - 12.7 cents)*1.582 - Class III fat price]

This formula derives its cheese yield factors for protein and fat from the Van Slyke Cheese

yield formula and adjusts the protein price for the differences between the value of fat in

cheese and the value of fat in butter. A major shortcoming of this proposed formula is that it

fails to recognize that the majority of cheddar cheese sold is sold in barrel form. Thus, it is

essential that the product formula be adjusted to be a weighted average of block and barrel

prices, weighted by usage. According to weekly cheese sales data from NASS, barrel sales

represent about 61% of the cheese volume and 40 pound blocks account for the remaining

39%.

The proposed cheese manufacturing allowance of 12.7 cents per pound is far too low,

reflecting the fact that the number was based on 1984 data from a Cornell University study by

Mesa-Dishington, Aplin, and Barbano (1986). We again want to emphasize the

inappropriateness of using 15-year old data to establish pricing formulas that will become

effective in 1999. Obviously, costs, plant scale, and technology have changed substantially

since this study was undertaken. A comprehensive survey of manufacturing costs for both

block and barrel plants should be undertaken as the basis for setting manufacturing

allowances. Data from USDA and CDFA indicate that the manufacturing costs for 40lb. blocks

are at least 17 cents per pound, while barrel manufacturing costs can be imputed to be at least

14 cents per pound based on the differences between the federal support purchase prices for these commodities. If a block-barrel weighted average price series is used, then a block-barrel weighted average manufacturing cost (equal to about 15.2 cents per pound) should be used in the formula as well. We include, as Attachment 4, data from CDFA on cheddar manufacturing costs in California.

The location value of cheddar cheese should also be reflected in the price formula. The reasoning that applies here is identical to that which we discussed in our comments on Class IV pricing. The existing NASS data show that block cheese values in the West are lower than in the Midwest (see Attachment 5). For the March 1997 through December 1997 period, this price difference averaged about 5.2 cents per pound, or approximately the cost of transporting cheese from California to Wisconsin. This difference in product value results in an approximate difference in cheese manufacturing milk value of 52 cents per hundredweight, assuming a cheese yield of 10 pounds per hundredweight of milk. Federal order formulas should use the applicable regional price series, or manufacturing milk could be seriously overvalued in some regions.

Class III – other solids

Under the proposed rule, the other solids price is calculated as a whey value and uses a monthly NASS dry whey price, less a manufacturing allowance of 10 cents per pound, divided by a yield factor of 0.968. In the past, Dairy Institute has not advocated the use of a dry whey value in the Class III formula for the following reasons:

- Whey disposal is viewed by many cheesemakers as a cost center rather than a profit center.

- Unprocessed whey (raw whey) has no inherent market value.

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- Whey disposal is an environmental liability.

- There are still some plants that do not process non-cream whey. California Department of Food and Agriculture data, put together for the most recent public hearing on Class 4b (cheese milk) pricing in California, appeared to indicate that over half the cheese produced in California comes from plants that have no whey recovery

- Cheese manufacturers have made huge investments in capital equipment for further processing whey, primarily as a means of minimizing the various costs and environmental liabilities associated with this byproduct. They have undertaken significant risks in making these investments and in developing these markets. Incorporating a dry whey value in the milk price would eliminate incentives for expansion of these kinds of innovative investments.

- Although there may be periods when processing and selling whey products earns returns over costs, for many cheesemakers it is typically a break-even enterprise, at best.

However, we do recognize that the market structure with respect to whey processing may be different in other parts of the country than it is in California. If a dry whey value is used in the Class III formula, then the manufacturing allowance and yield employed must be realistic. The manufacturing allowance on dry whey should be increased to around 17.5 cents per pound based on USDA Rural Cooperative Business Survey data. The make allowance of 10 cents per pound used in the proposed rule comes from a 1990 Cornell University study which used an economic engineering (theoretical) approach and employed cost data from 1988 (Hurst, Aplin and Barbano (1990)). Economic engineering approaches are appropriate for projecting the feasibility of certain enterprises when actual plant data are not available. They are also useful in establishing theoretical frontiers on plant efficiency. However, they should not be used to determine coefficients for regulated minimum pricing formulas. In addition, the age of the study and the data used also discredit the information as a basis for use in pricing formulas that will be effective in 1999.

The dry whey yield factor employed in the proposed rule does not allow for any product losses. Product losses are an inevitable part of almost any manufacturing operation. Therefore, the whey yield factor should be increased to at least a value of 0.98.

Class II – fat

The proposed Class II fat component price will be set equal to the Class IV and Class III fat price. Hence, the comments made by Dairy Institute on Class IV and Class III fat prices apply to Class II fat pricing and will not be repeated here.

Class II – skim

Under the proposed rule, a 70 cent per hundredweight differential will be added to the current month Class IV skim milk price (which is equal to the Class IV SNF price times 9) to determine the Class II skim price. Tying Class II prices to Class IV prices is economically sound because Class IV products are the alternative ingredients to fresh milk use in Class II manufacturing. However, there are two major problems with the Class II formula as proposed. The 70 cent per hundredweight differential is price-enhancing and furthermore, will create incentives to use powder in the manufacture of Class II products. Also, while the effort made by USDA to keep Class II prices in alignment with Class IV prices is laudable, accomplishing such alignment by eliminating forward pricing of Class II products would be extremely burdensome for the industry.

The reasoning used by the Department is establishing the 70 cent per hundredweight differential on Class II prices is that the cost of dehydrating milk and then rehydrating it for use in Class II manufacturing is approximately 70 cents per hundredweight. Following this logic, the Department maintains that as long as the Class II price differential is no greater than 70

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cents, there will be no incentive for reconstitution. In reality, prior re-hydration is not always necessary when using ingredients in Class II product manufacturing. Hence, a 70 cent differential could create substantial incentives to increase powder use in Class II, depriving dairy farmers of a higher revenue milk market. While it is true that some processors will not switch immediately to powder use for a transitory price advantage when Class II milk is expensive relative to other dairy ingredients, other processors make such substitutions routinely with little advance notice. Even those processors that are reluctant to substitute powder for fresh milk in Class II manufacture, may be more likely to do so when long-term incentive is built in to the regulated pricing structure. It is just as essential the prices be aligned properly across product form as it is that they be aligned properly across regions. The same principles of arbitrage apply. If an economic advantage can be gained by substituting one product form for another -- rest assured that someone will do it, and Class II usage will fall as a result. Given that full rehydration of powder is not always necessary in Class II manufacture, the upper limit on the Class II differential would be the cost of dehydration, or about 35 cents per hundredweight. Given that there is no shortage of milk available for Class I and Class II uses (i.e. the supply standard of the Agricultural Marketing Agreement Act is satisfied), there is little rational to increase the Class II differential. Therefore, a differential equal to 30 cents per hundredweight is suggested by Dairy Institute as appropriate for use in the Class II formula.

USDA's proposed use of the current month Class IV skim milk price in the Class II formula eliminates forward pricing of Class II milk. Forward pricing of Class II milk and Class II products is desired in the marketplace. Under USDA's proposed rule, processors would not know the cost of their Class II products until after they had already priced and sold them to customers. The prevailing business practices in Class II manufacturing and marketing make forward pricing of Class II milk a necessary feature of any federal order pricing formula.

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Therefore, Class II milk prices should be based on Class IV prices in either the second preceding month, as is currently the case under the orders, or an average of the two preceding months, as is the case for Class II pricing in California. Using and average of the two proceeding months allows for more recent data on Class IV prices to be incorporated in the construction of the Class II price, but also allows forward pricing, since most of the weekly butter and powder prices that will be used to construct the Class II price will be known in advance.

The Class I Price Mover

USDA's proposed Class I price mover is a 6-month declining average of the higher of the Class III price and Class IV butterfat and skim prices. A Class I differential would then be added to this Class I price mover to determine Class I prices in each order. While the 6-month moving average introduces some element of stability to the Class I price, it removes the crucial linkage between the Class I price and current manufacturing milk prices. Since manufacturers and processors compete for the same raw product, it is essential that these prices remain related to one another with some degree of timeliness. If prices are truly decoupled, there could be periods where Class I differentials are not large enough to ensure that milk moves to Class I uses. In such an event, processors would be forced to pay substantial over-order charges to get milk into fluid processing plants. When manufactured product prices fall, the new Class I mover will not respond as quickly as the old BFP, and as a result, the effective Class I differential (the current Class I price over the current Class III manufacturing milk value) will increase.

This "ballooning" effect in the Class I differential is compounded by the fact that Class I over-order charges tend to be somewhat sticky, and do not always fall immediately when

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manufactured product prices decline. Hence, processors will pay extra for milk when milk is scarce, but will be locked into paying higher prices for milk when it is abundant. The Department attempts to avoid the problem of the effective Class I differentials being squeezed in its proposed Class I mover by using the "higher of Class IV or Class III skim values." The result is that price are enhanced to the point where a substantial Class I differential is maintained in times of rising prices.

Attachment 6 shows just how large the price enhancement becomes. The graph also shows that the effective Class I differential "squeezing" still would have occurred using the new mover in the Autumn of 1996 and in the late Summer of 1997. Compensating for the shortcomings of decoupling through price excessive Class I price enhancement is poor policy given the dynamics of the Class I market. Therefore, basing the Class I price mover on the second preceding month should be continued. If price stability is a desired goal, an element of stability could be introduced by incorporating two-month Class I pricing into the federal orders. Two-month pricing results in less frequent price changes at wholesale and retail levels and has worked well for the California industry for many years.

Class I prices are enhanced from current levels by the inclusion of the "higher of" Class III or Class IV skim values in the price mover. California experimented briefly with the "higher of" concept in its Class I price formula and likewise found that it substantially enhanced prices. Additional Class I price enhancement seems to be poor public policy at a time when the industry is investing considerable sums to boost Class I sales. Increasing Class I prices works at odds with dairy farmer and milk processor investments in research and promotion. To remove the price enhancement element, it is suggested that the Class I price mover be tied to the Class III fat and skim values only, rather than the higher of Class III or Class IV. Class III is

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appropriate because it is the larger usage manufacturing product class, and ultimately should attain higher values than Class IV as support prices and product import barriers are eliminated.

Class I Differentials

Two Class I differential structures have been proposed by USDA. Option 1a largely maintains the current differential structure (with changes in a few markets), while Option 1b reduces the level of differentials and substantially flattens the interregional price surface. Option 1b also defines a Class I price for every county, with processors competing in the same general area sometimes having significantly different prices and hence, different raw product costs.

In general, a reduction in the aggregate level of Class I price differentials is sound policy. It has the benefits of leading to lower retail prices and greater consumption of Class I products. It also is less intrusive, and makes room for the market to direct Class I product flows. The problem with Option 1b however, is that it can change established raw product cost relationships for processors competing in the same general market area. Processors investments in plants and plant location decisions have been based in part on their raw product cost relationships with competing firms, and these raw product cost relationships have been directly tied to the current system of Class I price differentials. Radical departures from the existing Class I price surface (like Option 1b) could have a substantial impact on the traditional raw product cost alignment and would disrupt traditional competitive relationships.

For this reason, Dairy Institute supportive of the concept of starting with an Option 1a differential price surface, and then reducing the differentials over the following 9 years to a level equal to Option 1b differential levels or 75% of current differentials, whichever is higher. This process would move the industry toward less intrusive regulation and a more market-

oriented price surface, but would do so gradually, giving processing firms and producers more adequate time to adjust.

Product Classification

The major changes in product classification under the proposed rule include moving butter and all dried milks to a new Class IV designation. In addition, egg nog will be reclassified as Class I, while cream cheese will be moved from Class III to Class II. Dairy Institute supports the movement of butter and powder milks to a separate Class IV. This change brings the federal orders closer to California's pricing system. We do not support the movement of cream cheese to Class II and urge that it be retained in Class III. Cream cheese is functionally a butter substitute and hence it should remain classified with hard cheeses (the lower-priced class) rather than with yogurt and cottage cheese. In 1991, the Department addressed the classification of cream cheese and concluded that it was appropriate for cream cheese to be classified as Class III. The arguments and reasoning put forth by the Department at that time are still valid today. We urge the Department to revisit their own reasoning on this issue. The justification for up-classification of cream cheese in the proposed rule, specifically that cream cheese is a demand driven product that is not used for balancing, is weak. Cream cheese is storable for up to six months and thus its production can be used to balance supplies. Also, there are many other cheeses currently classified in Class III that are "demand driven". We urge the Department to maintain cream cheese as a Class III product.

Shrinkage

The Department's proposal that all shrinkage be assigned and classified on a pro rata basis according to the individual handler's usage should be changed. The current method of

allocating shrinkage of up to 2% of a plant's receipts to Class III provides more than adequate "incentive" to keep shrinkage to the minimum level possible. Shrinkage earns no return in the marketplace; hence, the fact that processors incur any obligation is sufficient to make processors strive for its reduction. Some shrinkage is inevitable in any milk processing operation as there are normal unavoidable milk losses when milk remains in pipelines, adheres to processing equipment, and is then washed away by routine plant cleaning. Plants with excessive amounts of shrinkage will incur the higher Class I obligation when their receipts in excess of accounted-for utilization exceed two percent. The current manner of classifying shrinkage should be maintained.

Identical Provisions

Dairy Institute is supportive of the efforts evident in the proposed rule aimed at creating greater harmony and uniformity with respect to the definition of producer handlers and their treatment under the orders. It is important, for the purpose of maintaining equal raw product cost, that the definition of producer handlers under the orders is not expanded to include processors that purchase substantial quantities of milk produced on farms or ranches other than those owned by the producer handler.

Dairy Institute hopes the Department will find these comments helpful. If we can be of any assistance or answer any questions regarding the issues we have raised please do not hesitate to contact us.

Comparison of Class 1 Mininum Milk Prices

Chart showing $ per cwt. on the y-axis (ranging from 11 to 18) versus Month / Year on the x-axis (from Jan-96 to dec). Two data series are plotted: "La..." (solid line with diamond markers) and "So..." (dashed line with square markers).
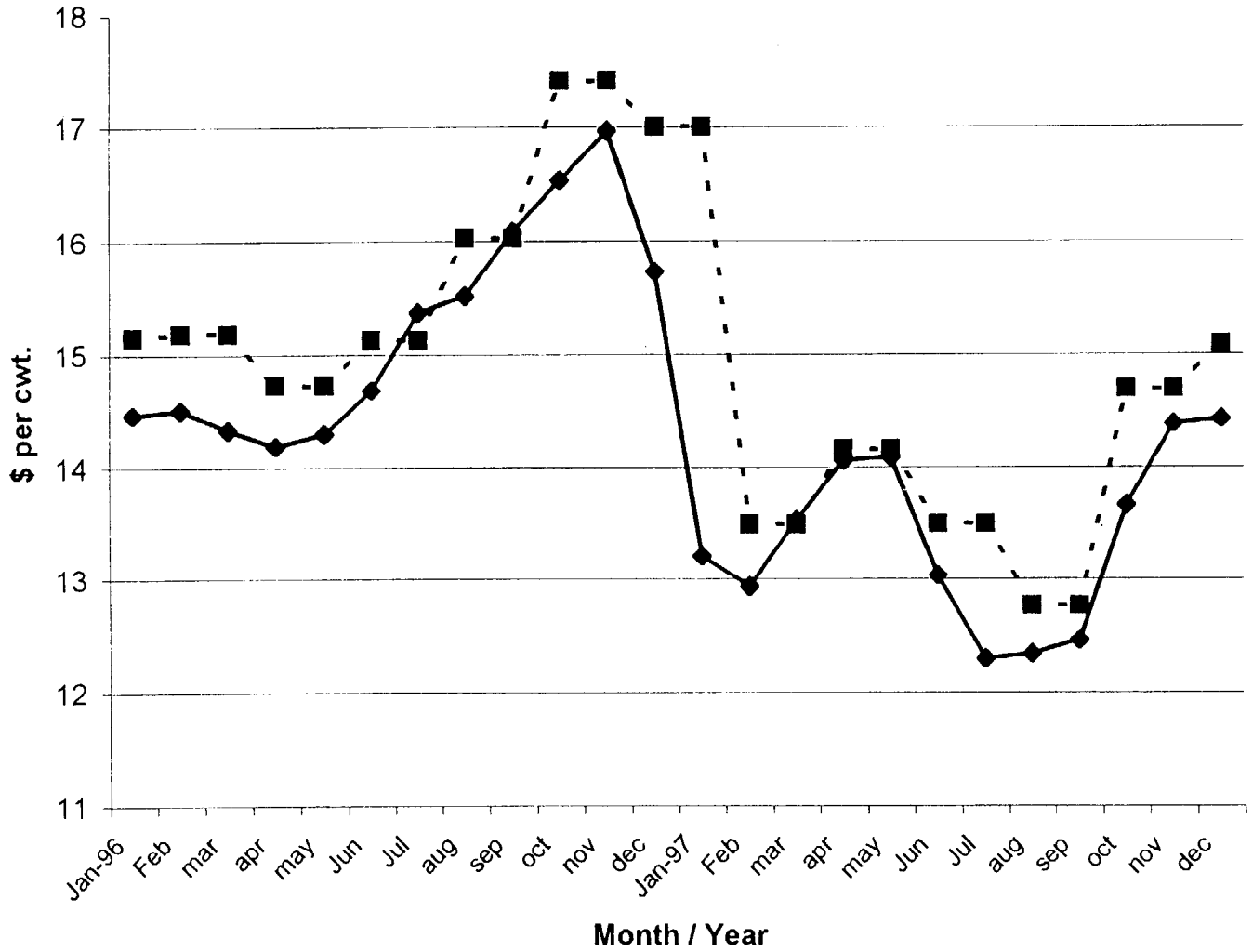
Difference Between CME and California AA Butter Prices, July 1996 - June 1997

		California Butter Price Grade AA ($/lb.)	CME Butter Price Grade AA 1/ ($/lb.)	Price Difference ($/lb.)
1996	July	1.4898	1.5150	0.0252
	August	1.4842	1.5300	0.0458
	September	1.4866	1.5300	0.0434
	October	1.3317	1.4180	0.0863
	November	0.7479	0.8306	0.0827
	December	0.7408	0.7938	0.0530
1997	January	0.8542	0.9020	0.0478
	February	0.9974	1.0663	0.0689
	March	1.1246	1.1575	0.0329
	April	0.9706	1.0360	0.0654
	May	0.9004	0.9550	0.0546
	June	1.0900	1.1294	0.0394

12 month average = 0.0538

Comparison of Western and Central Powder Prices 1994-1997

STATE OF CALIFORNIA
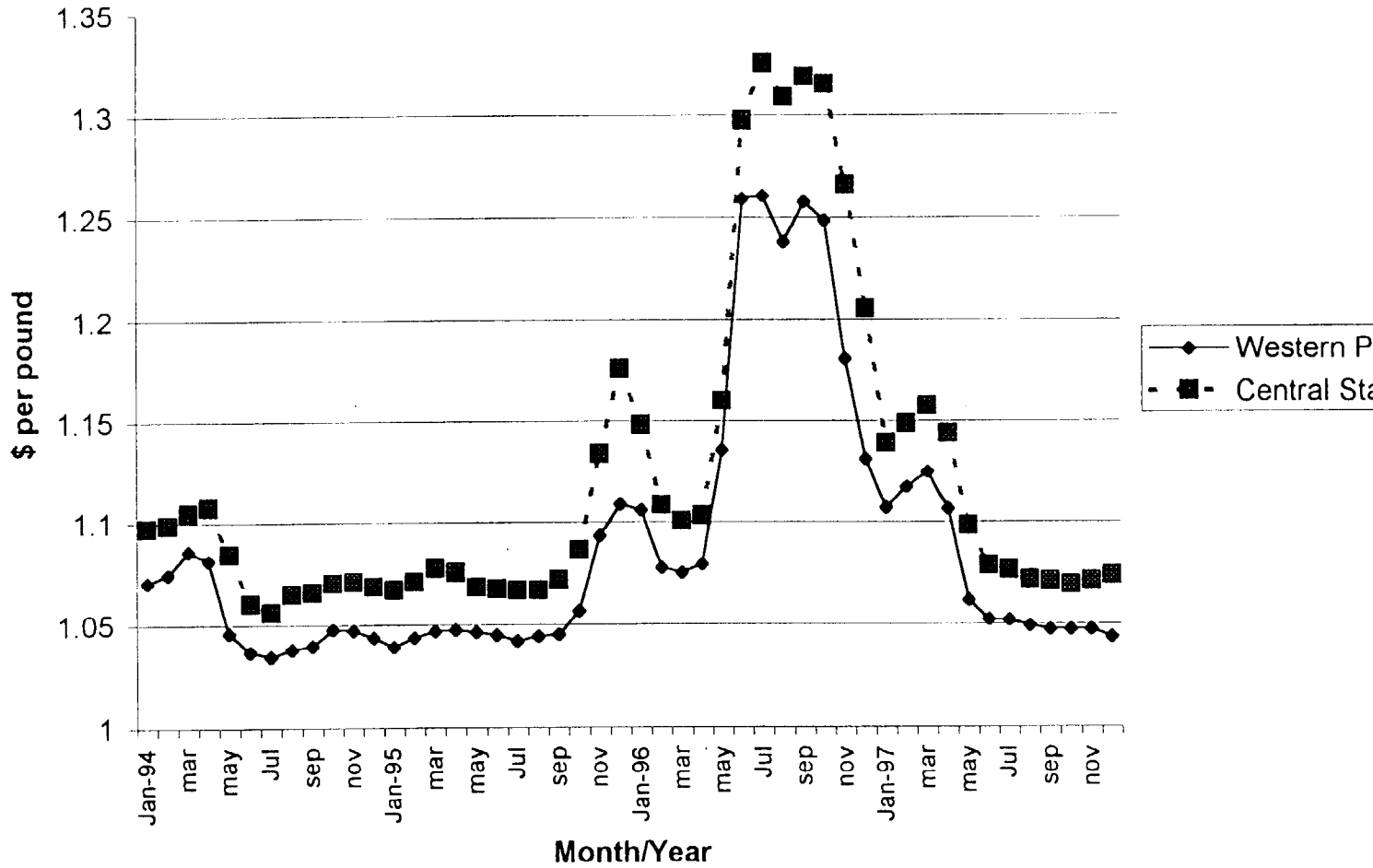
DEPARTMENT OF FOOD AND AGRICULTURE

1220 N Street Room A-224
Sacramento, California 95814
Phone (916) 654-1456
Fax (916) 654-0867

Attachment 4

July 15, 1997

TO THE PERSON ADDRESSED:

Attached are copies of latest Nonfat Powder, Bulk Butter and Cheddar Cheese costs for selected periods September 1994 to December 1996. This year there are two sets of figures for cheddar cheese; one with protein premiums paid to producers and one without.

Except as noted, the table below depicts the Weighted Average Manufacturing Costs for Butter (salted and unsalted), Nonfat Powder and Cheddar Cheese as published for the last eight years. Costs include Packaging, Processing Labor, Processing Non-Labor, General and Administrative, Return on Investment and, for Butter and Cheddar Cheese, Miscellaneous Ingredients. Also included is the number (#) of plants costed for each exhibit.

Exhibit Date	Butter*	Nonfat Powder	Cheddar Cheese
May 1989	0.0879 (11)	0.1370 (11)	0.2251 (9)
June 1990	0.0888 (11)	0.1398 (11)	0.2324 (9)
May 1991	0.0883 (10)	0.1438 (11)	0.2192 (9)
July 1992	0.0969 (12)	0.1443 (12)	0.2010 (9)
August 1993	0.0936 (12)	0.1430 (11)	0.1868 (10)
September 1994	0.0895 (11)	0.1341 (11)	0.1889 (8)
April 1995	0.0889 (9)	0.1327 (9)	0.1862 (8)
November 1995	0.0928 (9)	0.1328 (9)	0.1981 (8)
December 1996	0.0970 (9)	0.1333 (9)	0.1898** (8)
July 1997	0.0958 (8)	0.1327 (9)	0.1840*** (9)

* All butter costs, prior to November 1995, have been increased by $0.0027 per pound which is the weighted average cost of miscellaneous ingredients for November 1995.

** This and successive figures include costs associated with bulk cheddar plants, although packaging labor and packaging expenses reflect costs from the 40-lb. block plants.

*** If the $0.0226 protein premium paid to producers was included, the cheddar cheese manufacturing cost increases to $0.2066 per pound.

If you have any questions, please contact Tom Gossard or myself at the above number.

Sincerely,

Edward Hunter

Edward Hunter
Supervising Auditor I
Dairy Marketing Branch

Attachments

CHEDDAR CHEESE PROCESSING COSTS

FOR SELECTED PERIODS, CALIFORNIA, JANUARY 1995 TO DECEMBER 1996 1/
QUANTITY WEIGHTED AVERAGE PROCESSING COSTS 2/

PLANT GROUPS RANKED BY LOWEST COST 3/	NO. OF PLANTS IN GROUP	MISC. INGREDIENT	PACKAGE 1/	PROCESSING LABOR 1/	PROCESSING NONLABOR	GENERAL & ADMINIST.	TOTAL OPERATING COSTS	VOLUME COVERED 4/ 5/	RETURN ON INVESTMENT	TOTAL COST	VOLUME PROCESSED 5/ 6/
		($/lb.)						(percent)	($/lb.)		(lbs.)
GROUP 1	3	0.0117	0.0159	0.0523	0.0665	0.0192	0.1656	27.2%	0.0108	0.1764	259,384,036
GROUP 2	3	0.0260	0.0206	0.0472	0.0589	0.0244	0.1771	83.1%	0.0040	0.1811	72,920,626
GROUP 3	3	0.0128	0.0190	0.0793	0.0731	0.0312	0.2154	98.3%	0.0185	0.2339	43,334,535
											375,639,197
STATISTICS FOR 9 PLANTS											
SIMPLE AVERAGE		0.0170	0.0189	0.0603	0.0701	0.0261	0.1924	88.5%	0.0105	0.2029	
WEIGHTED AVERAGE 2/		0.0146	0.0172	0.0544	0.0658	0.0216	0.1736	76.8%	0.0104	0.1840	
MEDIAN		0.0122	0.0171	0.0628	0.0663	0.0251	0.1835	83.1%	0.0063	0.1898	

1/ COSTS REFLECT SELECTED ANNUAL PERIODS FROM JANUARY 1995 TO DECEMBER 1996; PACKAGE AND LABOR COSTS UPDATED TO MAY 1997.
2/ WEIGHTED BY POUNDS OF PRODUCT PROCESSED BY EACH PLANT.
3/ PLANTS HAVE BEEN GROUPED ON THE BASIS OF PROGRESSIVELY INCREASING PROCESSING COSTS WITH THE FIRST GROUP BEING THE LOWEST COST PLANTS
4/ THE VOLUME COVERED IS THE CUMULATIVE VOLUME OF ALL PLANTS WHOSE ACTUAL COSTS ARE LESS THAN OR EQUAL TO THE LISTED AVERAGE COST.
5/ INCLUDES BOTH CHEDDAR AND MONTEREY JACK FOR VOLUME. COSTS, MOISTURE, FAT, SNF AND YIELDS ARE FOR 40 LB. BLOCKS OF CHEDDAR ONLY.
   THREE CHEESE PLANTS MAKE 500 LB. BARRELS OR 640 LB. BLOCKS. FOR THESE THREE PLANTS, THE PACKAGING COSTS WITH THEIR ASSOCIATED PR
   REPLACED BY THE AVERAGE PACKAGING COSTS WITH THEIR ASSOCIATED PROCESSING COSTS OF THE SIX 40 LB. BLOCK PLANTS
6/ THESE NINE PLANTS PROCESSED 98.9% OF THE CHEDDAR AND MONTEREY JACK CHEESE IN CALIFORNIA IN 1996.

DAIRY MARKETING BRANCH, CDFA

JULY 1997

DMB-PC-97:103

CHEDDAR CHEESE PROCESSING COSTS

FOR SELECTED PERIODS, CALIFORNIA, JANUARY 1995 TO DECEMBER 1996 1/
QUANTITY WEIGHTED AVERAGE PROCESSING COSTS 2/
INCLUDES COSTS OF PROTEIN PREMIUMS

PLANT GROUPS RANKED BY LOWEST COST 3/	NO. OF PLANTS IN GROUP	MISC. INGREDIENT 7/	PACKAGE 1/	-- PROCESSING -- LABOR 1/	NONLABOR	GENERAL & ADMINIST.	TOTAL OPERATING COSTS	VOLUME COVERED 4/ 5/	RETURN ON INVESTMENT	TOTAL COST	VOLUME PROCESSED 5/ 6/
						($/lb.)		(percent)	($/lb.)		(lbs.)
GROUP 1	3	0.0142	0.0156	0.0520	0.0713	0.0194	0.1725	18.6%	0.0089	0.1815	181,010,578
GROUP 2	3	0.0253	0.0228	0.0744	0.0565	0.0223	0.2012	53.5%	0.0133	0.2145	57,142,740
GROUP 3	3	0.0725	0.0168	0.0493	0.0623	0.0242	0.2252	98.3%	0.0111	0.2363	137,485,879
											375,639,197
STATISTICS FOR 9 PLANTS											
SIMPLE AVERAGE		0.0313	0.0189	0.0603	0.0701	0.0261	0.2067	56.2%	0.0105	0.2172	
WEIGHTED AVERAGE 2/		0.0372	0.0172	0.0544	0.0658	0.0216	0.1962	53.5%	0.0104	0.2066	
MEDIAN		0.0168	0.0171	0.0628	0.0663	0.0251	0.1881	53.5%	0.0063	0.1944	

1/ COSTS REFLECT SELECTED ANNUAL PERIODS FROM JANUARY 1995 TO DECEMBER 1996; PACKAGE AND LABOR COSTS UPDATED TO MAY 1997.
2/ WEIGHTED BY POUNDS OF PRODUCT PROCESSED BY EACH PLANT.
3/ PLANTS HAVE BEEN GROUPED ON THE BASIS OF PROGRESSIVELY INCREASING PROCESSING COSTS WITH THE FIRST GROUP BEING THE LOWEST COST PLAN
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5/ INCLUDES BOTH CHEDDAR AND MONTEREY JACK FOR VOLUME. COSTS, MOISTURE, FAT, SNF AND YIELDS ARE FOR 40 LB. BLOCKS OF CHEDDAR ONLY.
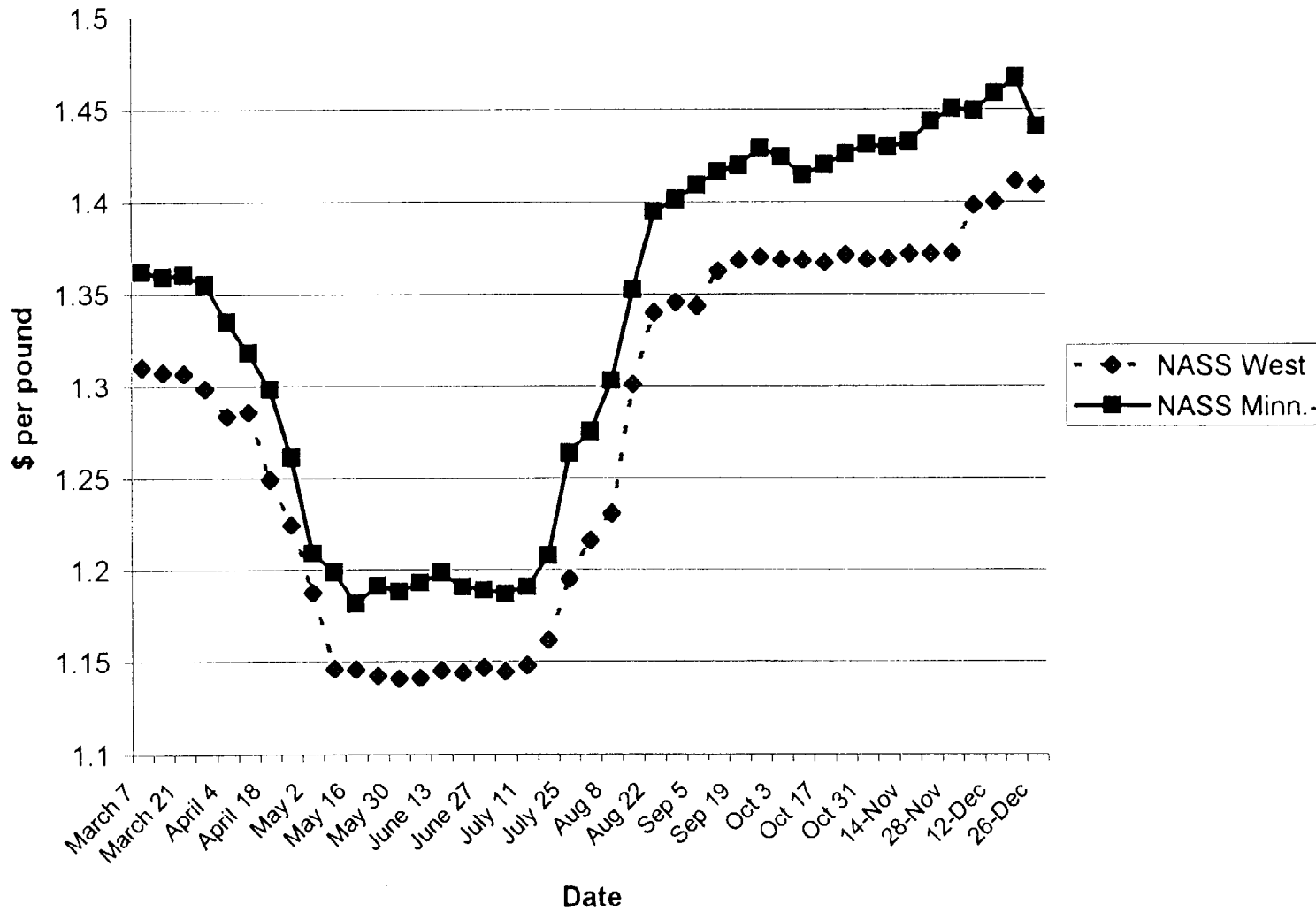   THREE CHEESE PLANTS MAKE 500 LB. BARRELS OR 640 LB. BLOCKS. FOR THESE THREE PLANTS, THE PACKAGING COSTS WITH THEIR ASSOCIATED I
   REPLACED BY THE AVERAGE PACKAGING COSTS WITH THEIR ASSOCIATED PROCESSING COSTS OF THE SIX 40 LB. BLOCK PLANTS
6/ THESE NINE PLANTS PROCESSED 98.9% OF THE CHEDDAR AND MONTEREY JACK CHEESE IN CALIFORNIA IN 1996.

1997 NASS 40 lb. Block Prices, West and M-W

Date

Legend:
- - ◆ - NASS West
- ■— NASS Minn.-

Computed Class I Prices Using the Old and New Clas[s]
Movers and Current Class I Differentials

Month / Year