

UNITED STATES DEPARTMENT OF AGRICULTURE
AGRICULTURAL MARKETING SERVICE

IN RE:	)	
	)	
MILK IN THE NORTHEAST AND	)	
OTHER MARKETING AREAS;	)	Docket Nos
PROPOSED AMENDMENTS TO	)	AO-14-A74, et al.;
TENTATIVE MARKETING	)	DA-06-01
AGREEMENTS AND ORDERS	)	

**LEPRINO FOODS COMPANY’S BRIEF AND PROPOSED FINDINGS AND
CONCLUSIONS IN REGARDS TO PROPOSALS TO AMEND THE CLASS III AND
CLASS IV MILK PRICE FORMULA MANUFACTURING ALLOWANCES.**

INTRODUCTION AND SUMMARY

Pending before the United States Department of Agriculture (“Department”) are proposed amendments to the Class III and Class IV milk price formula manufacturing allowances applicable to all Federal Milk Marketing Orders (“Orders”). The hearing on these matters was held January 24 - 27, 2006, in Alexandria, Virginia (“Hearing”). Leprino Foods Company (“Leprino”) is submitting this Brief to assist the Department in its analysis of the testimony provided at the Hearing regarding Class III and IV milk pricing.

Evidence presented at the Hearing supports the following conclusions:

1. The Department should issue a decision on an emergency basis.
2. The make allowance for cheese should be set no lower than 18.1 cents per pound of cheese.
3. The make allowance for dry whey should be set no lower than 22.22 cents per pound of dry whey.
4. The make allowance for butter should be set no lower than 15.4 cents per pound of butter.
5. The make allowance for nonfat dry milk should be set no lower than 19.7 cents per pound of nonfat dry milk.

The following is further elaboration on the record evidence supporting these conclusions:

1. The Department should issue a decision on an emergency basis.

The need for relief for manufacturers operating under the Orders is urgent and warrants an expedited rule. Costs have increased significantly from the base period of 1997 –

1999 that was used to establish the current make allowances. The fixed relationship between finished product prices and the Class III and IV formula milk prices limits the marketplace's ability to adjust for these changes. Consequently, the long-term viability of manufacturers is being threatened by the shortfall between the make allowances in the current Class III and IV formulas and current costs.

The increase in manufacturing costs since the 1997 to 1999 base period that has been experienced by manufacturers across the country warrants an amendment to all Orders. Numerous company witnesses testified regarding the increase in costs. The Lactalis American Group witness testified that "natural gas costs increased 167% comparing 1998 annual average costs to 2005 average annual costs... Water costs have increased by 69% since 1998... Wage rates are up 37% from 1998 to 2005 but medical insurance costs are up by 97% during that same time period" [Carlson, Tr. Vol II, page 311, line 15]. The Foremost Farms witness testified that, despite numerous cost saving initiatives, several costs increased from 1999 to 2004. These included "natural gas up 64.1%, electricity up 70.3%, employee fringe benefits (driven by increasing health insurance costs) up 57%." [Weiss, Tr. Vol. III, page 50, line 4]. The Davisco witness testified that "From 1998 to 2004 our packaging costs have increased 15% per pound of cheese produced, our direct labor costs have increased 25% per man hour, our indirect labor costs, which would include health care and benefits, have increased 92%. To put the health care number in perspective... our costs for natural gas from 1998 to 2004 have increased 149% on a per therm basis." [Davis, Tr. III, page 105, line 18]. The Saputo witness testified that from 2000 to 2005, "transportation, fuel, chemicals, employee health care-related benefit costs have all escalated significantly." [Dryer, Tr. III, page 313, line 15]. The Glanbia witness testified that they have experience significant increases in costs from 1999, including a 34% increase in electricity rates, 370% increase in natural gas rates, 44% increase in labor rates, 90% increase in health care costs, among other cost increases [DeKruyf, Tr. Vol. III, page 392, line 9]. Although the individual company testimony varied in terms of the timeframes compared and shows some variability by cost element, all of the company testimony reflected significant increases in costs.

The individual company testimony corroborates the results of the cost studies that were used as the basis of the current make allowances. The California Department of Food and Agriculture ("CDFA") and the Rural Business Cooperative Service ("RBCS") cost studies were used as a basis for the current make allowances that apply to cheddar cheese, butter, and nonfat dry milk in the Class III and IV formulas. The most recent study results show increased costs of manufacturing for all of these dairy products. These studies, taken collectively, represent the major dairy manufacturing regions of the country. Clearly, the increase in costs are not isolated to one region but are national in scope and warrant an update of the Class III price formula that applies to all Orders

The need for relief is urgent. Several other witnesses testified extensively about the urgency of implementation of an updated make allowance. Agri-Mark testified that "Proposal # 1 was submitted by Agri-Mark in order to address a very serious crisis faced

by its member-owners and its operations as well as the operations of all dairy product manufacturers who use Class III and IV milk pooled under Federal Milk Marketing Orders” [Wellington, Tr Vol I, page 296, line 10]. The witness went on to state that Agri-Mark “members cannot keep bearing millions of dollars in losses indefinitely. The only reasonable alternative if nothing is done is to consider closing or severely down-sizing all our plants” [Wellington, Tr Vol I, page 337 line 18]. Additionally, the witness stated that “A number of manufacturing plants in the Northeast milk marketing area where Agri-Mark members farm have ceased production recently and class pricing problems have played a role in these closings” [Wellington, Tr Vol I, page 300, line 2].

The reduction in manufacturing capacity leads to disorderly marketing due to the associated loss of balancing capacity. The Agri-Mark witness stated that Class III and IV plants “balance Class I and II needs seasonally and on weekends and holidays” [Wellington, Tr Vol I, page 304, line 4]. During 2005, statistics from the Northeast Order show that “Class III usage ranges from a high of 107% in May to a low of 92% of the average in October. Class IV usage ranged from a high of 145% in May to a low of 48% in September.” [Wellington, Tr Vol I, page 302, line 4]. He went on to say that “It is particularly important that the amended manufacturing allowances be in place in early spring... As losses to the Class III and Class IV plants keep mounting, those plants will likely be willing to take less and less, which will likely result in disorderly marketing conditions and lower prices to dairy farmers.” [Wellington, Tr Vol I, page 342, line 3].

2. The make allowance for cheese should be set no lower than 18.1 cents per pound of cheese.

The cheese make allowance should be increased to 18.1 cents per pound cheddar to be consistent with current CDFA and RBCS study costs. The methodology used to determine the 18.1 cents is consistent with the methodology that was used to establish the current make allowance with the exception that the costs in the RBCS study have been refined to reflect 40# cheddar block plant costs only. This refinement is an enhancement since the price formula is based upon 40# cheddar blocks.

A minimum of a 7.1% increase from the current 16.9 cent cheddar make allowance to the proposed 18.1 cent cheddar make allowance is supported by the testimony of several companies. The Lactalis American Group witness testified that they have experience a “14% increase in the average cost of producing a pound of mozzarella cheese from 1999 to 2005... The plant capacity was increased by over 25% during that time in order to decrease unit costs by taking advantage of efficiencies of a larger scale operation.” [Carlson, Tr. Vol II, page 311, line 1]. The Alto witness testified that the increases in energy costs, packaging film, cleaning chemicals and freight surcharges on inbound and outbound goods, and healthcare costs, in combination with increases in other costs, have resulted in “an increase in Alto’s cost of production of over 3 cents per pound” [Schuerman, Tr. Vol II, page 330, line 18]. The Foremost Farms witness testified that, in regards to their 640# cheddar block plant at Lancaster, Wisconsin, “In 2004, our total surveyed manufacturing costs per pound of cheese were 25.6% higher than in 1999 while total pounds of cheese manufactured at Lancaster were up by 3.3%” [Weiss, Tr. Vol III, page 49, line 19].

3. The make allowance for dry whey should be set no lower than 22.22 cents per pound of dry whey.

The make allowance for dry whey should be set no lower than 22.22 cents to reflect the cost of drying nonfat dry milk plus the incremental cost of drying whey. This proposed approach for establishing the dry whey make allowance is a departure from the methodology used to establish the current whey make allowance. However, the lack of a whey cost study that is representative of typical dry whey plants outside of California precludes using the same approach to establish dry whey make allowances as is used to establish the make allowances for the other products in the Class III and IV formulas.

Several aspects of the RBCS dry whey cost study are problematic. First, the participating plants are much larger on average than typical sweet whey plants. "The average US whey plant size in 2004 produced 25.6 million pounds, less than half the 59.5 million pound average volume per plant in the RBCS survey. The average plant size fall within a reasonably tight range across the regions, spanning from a low of 24 million pounds whey to a high of 28 million pounds whey. Economies of scale are very important in whey because of the significant capital costs associated with whey processing. The significantly larger plant size in the RBCS study is likely contributing to a lowering of the survey results below the levels achievable by many sweet whey plants" [Taylor, Tr. Vol. IV, page 291, line 10]. The Land O' Lakes witness testified that they participated in the RBCS whey cost survey with cost data from their Kiel whey drying facility. However, they do not think the costs are "representative of industry norms. The whey drying operation at Kiel dries the whey produced at the Land O'Lakes cheese plants in Kiel, Denmark and Greenwood, Wisconsin... Denmark and Greenwood ship their condensed whey to Kiel for drying, which allows Kiel to run at almost 100% capacity... the pre-unit efficiency of the whey drying activity at Kiel is dependent on the three-plant system that has evolved in that area, and we believe it is not representative of the industry norms." [Schad, Tr. Vol. II, page 38, line 10].

The second area of concern regarding the RBCS dry whey cost study is the omission of certain relevant costs in the reporting by the participating cooperatives. The West Farm Foods witness testified that they submitted data for the RBCS whey processing cost study for their Sunnyside, Washington plant. They stated that: "In our Sunnyside cheese / whey plant, about 22.5% of our processed whey is received as condensed whey from another plant. That whey is condensed off-site to about 20% solids and transported to Sunnyside where it is further condensed and dried. Of course, those costs are part of our total whey drying costs, and should have been included in our whey costing" [McBride, Tr. Vol III, page 346, line 4]. Additionally, no assembly and transportation costs were incorporated into the costs. These omitted costs were estimated by the witness to total 8.75 cents. When the cost incurred on the 22.5% of our whey intake is spread across all of the whey processed at our Sunnyside plan, the cost increase equals an additional 1.969 cents per pound of all whey processed" [McBride, Tr. Vol. III, page 347, line 8]. The Agri-Mark witness stated that the RBCS study includes scale efficiencies achieved by consolidation of condensed whey, but

does not incorporate condensing costs or transportation costs [Wellington, Tr Vol I, page 323, line 12].

Most of the plants in the whey survey did receive outside condensed whey and none of them incorporated transportation costs incurred in order to accumulate the large quantities of whey that allowed their plants to run more efficiently and at a larger capacity than they otherwise would. These omissions result in a serious understatement of actual whey processing costs.

The use of the RBCS nonfat dry milk manufacturing costs and the incremental costs associated with drying whey is the best solution in the context of the lack of a national whey cost study. A technical witness from WestFarm Foods analyzed the differences in costs attributable to whey that are absent from the nonfat dry milk manufacturing process. He analyzed these costs under two different systems and concluded that, under a more traditional system, “the whey processing estimates showed a whey drying cost difference of 2.559 cents over nonfat dry milk. When updated to 2005 energy costs, that difference grows by almost half a cent to 2.905 cents. The whey drying system used by WestFarm Foods substitutes somewhat lower capital costs, energy costs, and depreciation for the cost of membrane replacement. Based on this whey drying system, we calculate the 2.71 cent cost difference between whey and nonfat dry milk. He goes on to say that: “In summary, it appears that regardless of the process method used, the lower solids level of diluted whey compared to nonfat dry milk results in significantly higher costs for whey removal. These additional costs must be considered when determining a manufacturing allowance for whey. [Burleson, Tr. III, page 157, line 13].

The increase in the dry whey make allowance is also supported by individual company testimony. The Lactalis American Group witness testified that “the cost of producing a pound of whey at the Buffalo facility has increased 32%” from 1998 to 2005 [Carlson, Tr. Vol II, page 312, line 10]. The proposed whey make allowance of \$0.2215 is also consistent with the cost that would be determined by adding the change in Leprino’s sweet whey processing cost since the survey period that was used to establish the current whey make allowances. Leprino’s change in sweet whey manufacturing costs since 1999 is 5.4 cents per pound sweet whey. “When added to the 15.9 cent make allowance (the average NCI survey whey cost from the time), the new make allowance would be \$0.213, just slightly less than that proposed by Agri-Mark” [Taylor, Tr. Vol. IV, page 296, line 8].

4. The make allowance for butter should be set no lower than 15.4 cents per pound of butter.

The butter make allowance should be increased to 15.4 cents per pound butter to be consistent with current CDFA and RBCS study costs. The record provides ample detailed evidence in support of this proposed change.

5. The make allowance for nonfat dry milk should be set no lower than 19.7 cents per pound of nonfat dry milk.

The nonfat dry milk make allowance should be increased to 19.7 cents per pound nonfat dry milk to be consistent with current CDFA and RBCS study costs. The record provides ample detailed evidence in support of this proposed change.

Conclusion

The Hearing record is replete with evidence that manufacturing costs have increased significantly since the time period of the cost surveys used to establish the current make allowances. Leprino urges the department to update the make allowances on an emergency basis so that the manufacturing plant capacity necessary to sustain orderly marketing conditions is maintained.

Respectfully submitted,

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