BEFORE THE SECRETARY OF AGRICULTURE
AGRICULTURAL MARKETING SERVICE

In the matter of:	)	
	)	
Proposed Amendments of Tentative	)	Docket No.
Marketing Agreements and Orders	)	A0-14-A76, *et al.*
	)	
(Class I/II Price Formulas)	)	DA-07-01
	)	

Post-Hearing Brief of the National Milk Producers Federation

The National Milk Producers Federation (NMPF) hereby submits its post-hearing brief in the above-captioned proceeding. NMPF is an association that represents the interests of 50,000 of America's estimated 60,000 dairy farmers.

The Agricultural Marketing Service (AMS) of the U.S. Department of Agriculture ("the Department") initiated this proceeding to consider proposals submitted by NMPF to simplify and update the method of calculating the prices that producers receive for milk used in Class I and Class II milk products. NMPF proposes that USDA:

1. **Add 77¢ per hundredweight to the Class I milk price by updating the cost-based elements of the national minimum Class I milk price.**
2. **Simplify the calculation of the cheese-based skim milk price used in setting the Class I skim milk price.**
3. **Simplify the calculation of the butter-and-powder-based skim milk price used in setting the Class I skim milk price.**
4. **Simplify the calculation of the Class II skim milk price by removing two redundant and offsetting expressions of the nonfat dry milk make allowance.**
5. **Calculate the Class II butterfat price similarly to the minimum Class I butterfat price.**

NMPF seeks these changes for a number of reasons. First, producers and handlers participating in Federal milk marketing orders have experienced significant increases in the costs associated with supplying Class I and II milk since price formulas were established during Federal order reform. Second, the purposes of the Act will be better achieved by simplifying Federal order Class I and Class II price formulas. Third, the Class II butterfat price has been unnecessarily constrained by an inappropriate conformance to the Class II skim milk calculation.

NMPF's proposes amendments to Class I and II prices that would reestablish their relationship to Class III and IV prices, through dairy product prices. These amendments would update key cost elements in the current formulas. NMPF's proposals are founded on well-established Federal order principles. Federal order language to effect these changes was attached to the statement of NMPF's principle witness at the December 11 hearing. (Exhibit 5)

NMPF commends the timeliness of AMS's hearing on these issues and anticipates an expedited decision that will promptly address the unintended impact that AMS's tentative final decision on make allowances will have on Class I and II prices. NMPF's proposals would fully or partially offset that unintended impact, thereby allowing Federal order pricing to compensate Class III and Class IV manufacturers for their increased costs without penalizing producers who supply Class I and Class II products.

This brief restates NMPF's position; but more importantly, it clarifies the record with respect to numerous issues raised at hearing.

1. Basis for Emergency Consideration.

NMPF's proposals do not depend, in principle, upon the results of the make allowance hearing, i.e., Docket No. AO-14-A74, et al. (hereinafter, "Make Allowance Decision."). A timely decision on NMPF's proposals is, however, necessary to prevent economic hardships that dairy producers will experience if the Make Allowance Decision is applied in calculating Class I and II prices. USDA estimates that the Make Allowance Decision will reduce producer revenues by $191 million in the first year, and that $93 million of that is due to the application of the new make allowances to Class I and II price formulas. (71 FR 67468-67469) USDA also estimates that NMPF's proposals would increase producer income and, so, offset those losses. (71 FR 67492) Although NMPF supported increased make allowances to allow for the higher costs that manufacturers of Class III and Class IV products have recently experienced, it would be inequitable not also to address the higher costs that have been experienced by producers who supply Class I and Class II milk.

The Class I and II price formulas were defined during order reform in 1998. The specific cost elements in those formulas have not been updated since that time despite substantial cost increases. AMS received testimony during the hearing that current Class I and II prices are inadequate to ensure the orderly marketing mandated by the Act. An expedited decision is necessary to correct this problem.

2. <u>NMPF Proposes New Class I and II Formulas.</u>

NMPF has proposed simplified and updated Class I and II formulas based directly upon dairy product prices. These proposals were discussed in detail in the original

petition and in NMPF's testimony. They are restated here in order to help clarify points raised during the hearing.

NMPF's proposals update the Class I and II price calculations for the first time since the Federal order reform decisions in the late 1990's. NMPF also proposes to simplify the Class II skim milk price formula based upon the logic of the Federal order reform Class II calculation. Because Class II skim condensed milk competes with nonfat dry milk powder for many uses, it should be priced in a way that does not provide incentives for drying and reconstituting Class IV milk for Class II use. At the same time, NMPF recognizes that the Class II butterfat price is not similarly affected by potential dairy product substitution, and that Class II uses are comparable to Class I uses with respect to supply requirements and marketing channels. For these reasons, NMPF proposes that the Class II butterfat price be calculated similarly to the minimum Class I butterfat price.

A. Class I Skim Milk Formula

Assuming implementation of the Make Allowance Decision, the Class I skim milk mover formula, per hundredweight, will be equivalent to the higher of:

Nonfat dry milk price x 8.9 - $1.40

or

Cheese price x 10.0 + Dry whey price x 6.1 – Butter price x 3.9 – $2.40.

These simplified formulas incorporate product yields and aggregate make allowances per hundredweight of skim milk.

NMPF proposes a new Class I skim milk price mover, equal to the higher of:

NDM price x 8.9 – .63

or

Cheese price x 10.0 + Dry whey price x 6.1 – Butter price x 3.9 - $1.63

These formulas include all current Class III and IV make allowances and yield factors, as well as a Class I adjuster which combines the current product conversion costs and estimated changes (77¢) in the estimated per hundredweight costs of supplying Class I milk. Simply stated, NMPF's proposal is the current formula, simplified, plus 77¢.

At the time of Federal order reform, certain costs of supplying Class I milk were explicitly incorporated into the minimum Class I differential. These costs should be updated just as Class III and IV manufacturing costs are being updated. These cost modifications may be applied with equal effect to the Class I base price formula or the Class I differentials. However, it would be simpler and more straight-forward to apply these cost changes to distinct Class I skim and butterfat movers, which are calculated directly from the dairy products prices.

The Class I skim milk price and Class II price are currently calculated using the Class III and IV price formulas by reference, adding differentials that are that are designed to reflect their relationship to Class II and Class IV values. These cost differentials are intended to compensate suppliers of Class I and II raw milk, not processors. In the Proposed Rule for Order Reform, USDA set the minimum Class I differential at $1.60 per hundredweight, based upon three sets of costs. First are the costs of maintaining Grade A standards:

> There are several requirements for producers to meet to convert to a Grade A dairy farm and then maintain it. A Grade A farm requires an approved water system (typically one of the greatest conversion expenses), specific facility construction and plumbing requirements, certain specifications on the appearance of the facilities, and

> specific equipment. After achieving Grade A status, producers must maintain the required equipment and facilities, and adhere to certain management practices.[1] Often, this will require additional labor, resource, and utility expenses. It has been estimated that this value may be worth approximately $0.40 per hundredweight. [63 FR 4908]

In this proceeding , NMPF urges that the 40¢ reflecting pooled Grade A value cited at 63 FR 4908 be increased in proportion with the non-feed costs of milk production, because those costs serve as a fair proxy for the various costs associated with establishing and maintaining Grade A status. Several witnesses argued that producer costs specific to establishing and maintaining Grade A standards are far below 40¢ per hundredweight, but they had missed the point.. The January 30, 1998, notice of the proposed rule made it very clear that the 40¢ applied to the current Class I price was <u>not</u> the estimated cost of maintaining Grade A status per hundredweight of milk.[2] Rather,

> This is the value associated with Class I milk. The amount of this value actually returned to a producer is dependent upon a marketing order's Class I utilization and is reflected in the blend price. For example, in the proposed Upper Midwest order approximately $.06/hundredweight would be returned to producers to cover the costs associated with maintaining Grade A milk supplies.

That is, the element of the Class I price intended to compensate producers for establishing and maintaining Grade A status should be set equal to the producer cost per hundredweight of meeting Grade A standards, divided by the Class I utilization in the Upper Midwest Market, the surplus market for which the minimum Class I price is based. This inflation sets the additional Class I value so that it is adequate to compensate all pooled producers for maintaining this status. The example offered in the 1998 proposed

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[1] Management expenses include costs of hot water and steam for sanitation, additional bedding material, more frequent cleaning, and purchase of additional supplies and services necessary to maintain Grade A status. All these costs rise as processors' costs do. The same 1998 proposed rule recognized that the costs of conversion were not necessarily relevant, given the substantial conversion of U.S. milk production to Grade A. (This is a successful outcome of the Federal order system.) Instead, it considered the costs of maintaining Grade A status. Capital expenditures don't last forever, however, so in the long run, conversion and maintenance costs are the same.

[2] *See* 63 FR 4908, note_28.

rule indicated that 40¢ would return 6¢ to producers for these costs; however, on the same page and elsewhere in the proposed rule USDA anticipated that the consolidated Upper Midwest market would have a 20% Class I utilization (63 FR 4908). It is only reasonable to conclude that 40¢ divided by 20% Class I use was intended to return 8¢ per hundredweight to pooled producers to cover Grade A costs under the 1998 proposed rule. Today Class I utilization in that market is 16%.[3] This change alone justifies a 25% increase, from 40¢ to 50¢.[4]

Several witnesses identified partial costs of maintaining Grade A status that totaled substantially more than the 8¢ established above.¢. For example, Dennis Tonak, of Midwest Dairymen's Company, identified the amortized cost of a well on one farm at 7½¢ per hundredweight (Transcript p. 752). This does not, of course, account for the additional cost of energy required to cool milk from 50ºF to 45ºF, the additional costs associated with maintaining lower somatic cell or bacteria counts, or the costs associated with preparing for, and attending to, 1- 4 inspections annually rather than one bi-annual inspection. Mr. Tonak testified that several of these additional costs exist, but declined to quantify them. (Transcript pp. 763-764) Mr. Tonak even testified to the willingness of producers to "take a slightly less price or even a lot less price and only deal with an inspector every two years instead of dealing with an inspector every three months," a cost he also did not quantify. The total cost of achieving Grade A standards, including the producers' unwillingness to deal with frequent inspections, is certainly much more than 8¢ per hundredweight.

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[3] From *Dairy Market Statistics*, noticed at hearing, Transcript p. 1074.

[4] Any given Grade A cost divided by 16% is 25% greater than the same cost divided by 20%:

$$c \div 0.16\% = 125\% \times (\text{cost} \div 20\%)$$

Ronald Knutson, an expert witness for the International Dairy Foods Association (IDFA), and Robert Yonkers, IDFA's principle witness, both testified that no study of the additional costs of producing Grade A had been undertaken since that of Frank, Peterson, and Hughes ("The FPH Study"), which was published in 1977 and was based on data for 1974 and 1975. (Transcript, pp. 1142, 1256); The FPH Study is noted for the record at Transcript, p. 1295-1296)[5]

The FPH Study identified a number of additional costs associated with Grade A milk status, including additional disinfectants and sanitizers, greater upkeep of the milking facility, stainless steel equipment, more frequent replacement of equipment components to maintain somatic cell count standards, an additional hour's labor per day to maintain standards, and the general effort associated with more frequent state inspections. These additional non-feed milk production costs are indicative of the current differences between Grade A and Grade B standards.

According to the FPH Study, "[t]he cost of production was estimated as $0.23 to $0.32 greater for fluid eligible milk than for manufacturing grade milk in 1974 and $0.38 to $0.47 in 1975," (p.3) which are roughly consistent with processors' estimates of the "price differential they believed would be necessary to keep their fluid eligible producers on the fluid grade milk market." (p.2) One producer testified in the current proceeding that one Wisconsin cooperative now pays 90¢ per hundredweight more for Grade A than Grade B milk; this is about double what processors estimated was necessary in 1974/75. (Transcript, p. 608)

[5] Full citation: Frank, Gary G., G.A. Peterson, and Harlan Hughes. "Class I Differential: Cost of Production Justification", in *Economic Issues*, Number 8, April 1977. Published by the Department of Agricultural Economics, College of Agricultural and Life Sciences, University of Wisconsin-Madison.

In fact, comparison between the Grade A and Grade B standards in effect today and those in effect in 1974/1975 shows nearly identical differences in equipment, facility, and cooling requirements, as well as inspection schedules, and comparable differences in maximum allowable bacteria counts.[6, 7] The gap between Grade A and Grade B standards remains substantial, and at least as great as that which existed in 1975, as Grade A standards have become more exacting through a state-Federal process of review and revision culminating at the bi-annual National Interstate Milk Shippers Conference.

Non-feed costs in the production of milk, which closely correlate with "labor, resource, and utility expenses" plus infrastructure costs, have risen by 38% between 1998 and 2005, according to USDA estimates. (Exhibit 5, p. 9) Table 1, originally presented in Exhibit 5, and augmented using USDA data presented at the hearing as Exhibit 49, shows that average non-feed costs of milk production have risen 73% since 1980. This is the earliest year available, and given the clear trend shown in Table 1, it is evident that non-feed costs in 1980 were at least as high as in 1974-75.

Applying the 38% increase to the 40¢ cost

Table 1. U.S. Milk Production Costs per cwt, 1993-2005

	Feed	Non-Feed	Total
1980	4.86	7.78	12.64
1981	4.85	8.23	13.08
1982	4.72	8.22	12.94
1983	4.88	8.44	13.32
1984	4.91	8.61	13.52
1985	5.30	7.77	13.07
1986	5.06	7.70	12.76
1987	4.82	7.70	12.52
1988	5.90	7.98	13.88
1989	6.28	8.03	14.31
1990	6.09	8.64	14.73
1991	5.94	8.20	14.14
1992	5.68	8.26	13.94
1993	7.02	8.76	15.78
1994	7.17	9.32	16.49
1995	6.66	9.99	16.65
1996	7.53	9.60	17.13
1997	8.40	9.97	18.37
1998	7.51	9.74	17.25
1999	6.83	9.70	16.53
2000	6.49	11.53	18.02
2001	6.75	11.75	18.50
2002	7.01	11.86	18.87
2003	7.18	12.04	19.22
2004	7.47	12.36	19.83
2005	7.86	13.44	21.30

Source: USDA/ERS

[6] *Grade "A" Pasteurized Milk Ordinance*, Public Health Service, 1965. Also 1995 and 2005 Revisions, Public Health Service and Food and Drug Administration.
[7] *Milk for Manufacturing Purposes and it Production and Processing: Recommended Requirements.* USDA/AMS/Dairy Programs. These are standards for milk used to make USDA graded dairy products; these standards are not necessarily enforced for Grade B milk used to produce non-graded dairy products.

of maintaining Grade A supplies, NMPF conservatively estimates the present pooled cost of maintaining Grade A standards at 51¢ per hundredweight, an increase of 15¢ from the status quo. Applying 73%, which better captures the cost increase since the FPH Study, would result in an increase of 29¢.

NMPF's proposal of a 15¢ increase is conservative for two reasons. First, the original 40¢ was based upon a calculation anticipating a 20% Class I utilization in the consolidated Upper Midwest Federal Order. That utilization rate is now 16%, in the absence of de-pooling. (Dairy Market New 2005 Annual Summary, p. 28, noticed at Transcript, p. 1074) This factor alone would justify increasing the 40¢ pooled Grade A cost by 25%, to 50¢. Applying the more conservative 38% for increased non-feed costs results in an additional 19¢ increase, for a total of 29¢. Second, the FPH Study, the last meaningful study of Grade A costs, (cited by opponents of Proposal 1), concluded that Grade A standards cost in 1974-75 were between $0.23 and $0.47 per hundredweight. Inflating this by the 73% increase in non-feed costs of milk production since 1980 (the earliest year for which data is available) would increase these costs estimates to $0.40 to $0.81 per hundredweight. These adjusted figures, divided by the 16% Upper Midwest Class I use rate cited above, results in $2.50 to $5.06, at least a $2.10 increase in the Grade A element of the Class I price.

For comparison, the PPITW index of prices paid by farmers, compiled by USDA's National Agricultural Statistics Service, rose 182% from 1975 to 2005. (*Agricultural Prices, Annual Summary*. USDA/NASS. 1979 and 2005)

The second group of Class I costs defined by USDA were marketing costs. USDA's order reform decision also stated:

> Traditionally, the additional portion of the Class I differential reflects the marketing costs incurred in supplying the Class I market. These marketing costs include such things as seasonal and daily reserve balancing of milk supplies, transportation to more distant processing plants, shrinkage, administrative costs, and opportunity or 'give-up' charges at manufacturing milk plants that service the fluid Class I markets. This value has typically represented approximately $0.60 per hundredweight. [8]

This represents one element of "balancing". Balancing costs can be broken into three elements: 1) costs associated with meeting the minimum pooling and handler qualification standards in each Federal order market, 2) load-specific costs of delivering milk to a bottling plant over and above meeting minimum market standards, and 3) balancing services provided to the market over and above the minimum requirements. The second of these -- load-specific costs -- are typically and appropriately covered in over-order premiums. The third – balancing services -- may be covered by such programs as transportation credits or, intermittently, by further over-order premiums. However, the first set of costs -- for assembling a supply to meet minimum delivery standards -- are the costs addressed in the 1998 decision, and that element of the balancing which must be recovered through Class I (and II) prices formulas.

Most of these are the same costs associated with operation of plants producing such products as cheese, dry whey, butter, and nonfat dry milk powder. The operators of cooperative supply plants often sacrifice plant profitability of their manufacturing operations in order to provide Class I and II milk supplies. Their costs rise as energy costs and per-pound processing costs rise, and these costs should be offset in the Class I price. Shipping milk from distant sources imposes an even larger cost of balancing Class I markets; transportation costs also rise with higher energy prices, as has been acknowledged in a recent tentative partial decision on the transportation credits in the

[8] 63 FR 4908.

Southeast and Appalachian markets. (71 FR 54118, et seq.) The manufacturing costs estimated from the recent surveys tend to reflect costs of plants running near full capacity; processing costs of balancing plants are higher, and should be reflected in the Class I price. In addition, some part of the costs of plant operation are associated with maintaining certification to supply milk to Grade A fluid milk plants, costs that are required of a plant before it may be pooled in the Federal order system. Very conservatively, the same percentage increase in the costs of butter and powder manufacture (the primary form of market balancing through manufacturing) that is applied to Class III and IV make allowances should also be applied to the 60¢ supply cost. The data presented at the January hearing suggested a 22% increase the costs of converting milk into butter and powder. (Exhibit 5) This is based on a comparison of the 1998 butter-powder manufacturing costs determined by USDA as appropriate to the establishment of the previous make allowances (65 FR 76832, et seq.), and an application of the same method of aggregating to comparable data for 2004, as presented in Exhibit 58 at the January 2006 Make Allowance hearing. (Docket No. AO-14-A74, et al.) This increase is an "apples-to-apples" calculation. In contrast, the increase applied by USDA as a result of the Make Allowance Decision is based, in part, on an assessment of an alternative data source as preferable to the previous data sources alone for the specific purpose of revising make allowances[9]; but this does not allow for a direct comparison of costs in 1998 and 2004. For this reason and irrespective of the merits of the new data for establishing revised Class III and IV make allowances, the 22% calculation NMPF presented at hearing remains the most appropriate increase to apply to the 60¢ handler

[9] The sources applied in the Make Allowance Decision seem to be less inclusive of the balancing costs imposed upon some processing plants; this makes adequate compensation for balancing, through Class I and II prices and through such programs as the Transportation Credit program, all the more important.

fluid supply costs applied in the order reform decision. This increase would raise the Class I calculation by another 13¢ per hundredweight.

In addition, shifts in milk production and manufacturing consolidation have led to longer hauls to Class I plants, and under Federal order minimum pricing, hauling costs are borne by producers and their cooperatives. This was detailed in testimony both by supporters and opponents. (Exhibit 5, p. 11; Transcript, pp. 405, 440-441, 629, 703) Based upon various Market Administrator studies discussed in testimony and noticed at the hearing (Transcript p. 1296-1298), and based on the record in the ongoing transportation credit proceeding (71 FR 54118), NMPF conservatively estimates an additional 10¢ per hundredweight increase in average Class I assembly costs, for a total increase of 23¢ in this component of the original $1.60 Class I cost. This is another conservative estimate.

One study was offered into the record regarding hauling rates charged to dairy producers in Minnesota. (Exhibit 45, p. 35) This data does not necessarily represent the actual cost of hauling, and the rates may be subsidized by handlers. Aside from the distortion of results associated with potential subsidies in this source, the data simply do not reflect hauling costs across an entire market, only within a single state. Indeed, shifting supplies could be leading to shorter hauls for Minnesota producers, even as producers on the market generally face longer hauls to meet ever-declining local supply in certain markets. This source is clearly less relevant and less appropriate than the USDA data noticed and testified to at the hearing.

The third element of the minimum Class I price, per the proposed rule, was the "additional competitive factor", estimated at 60¢ per hundredweight based upon average

Grade A premiums above Class III milk. In 1995 and 1996 these averaged 86¢ in Minnesota and 89¢ in Wisconsin. (63 FR 4908-4909) By 2004-05, these average premiums had increased to $1.33 in Minnesota and $1.53 in Wisconsin. (Exhibit 5, p. 12)

In addition, the proposed rule considered the substantial over-order premiums paid for Class I milk in Chicago, Milwaukee, and Minneapolis in 1996, ranging from $1.19 to $1.79. By 2005, these over-order premiums were $2.10 in Minneapolis and $2.72 in Chicago and Milwaukee. These growing premiums indicate the inadequacy of the current minimum Class I prices to draw milk to the pool to meet Class I needs, and of their failure to meet the objectives of the Act.

In both cases, the competitive costs associated with Class I milk have risen by an average of about 65%. Applying this percentage increase to the 60¢ "competitive factor" incorporated at order reform would produce a 39¢ increase in the minimum Class I price.

Altogether, these considerations conservatively justify at least a 77¢ increase in the Class I skim milk price mover. One could easily argue that the full increase in average fluid premiums over manufacturing grade milk (or even in average over-order Class I premiums) should be applied to the Class I price. Proposal 1 is a modest one, aimed at striking a balance in the market.

Class I supply costs have changed over 10 years. It only follows from the updates in the Class III and IV make allowances that other cost-based elements of Class I and II prices should be updated, as well. These Class I and II supply costs (hauling, assembly, Grade A standards, etc.) are primarily borne by producers, directly or through the cooperatives that they own. To delay that update would deny fair and offsetting

compensation to producers, cooperatives, and other participants in the Federal order system.

Testimony in this hearing brought out very clearly the interaction of Class I prices and pooling standards. The pool provides value to Class I milk buyers, and minimum pooling standards require performance. This performance is the basis for the sharing of Class I value in the pool. In this way pooling with performance standards provides value to both the Class I distributing plant and the Class I raw milk supplier, and both sides must hold up their end. (See especially Transcript, pp. 1045-1060.)

For these reasons, and contrary to some testimony, the strengthening of pooling and producer qualification standards complement increased Class I prices, they do not make them unnecessary. Recent strengthening of such standards in some markets can reinforce the effectiveness of higher Class I prices in maintaining supplies for Class I handlers.

Several witnesses argued that prices were currently adequate to supply milk. Adequate short-run prices can be inadequate long-run prices. A price adequate to attract available production in the short-run may not be adequate to maintain that same production in the long-run, as evidenced, for example, by production losses in the Southeast. (Transcript, pp. 416-418)

Several witnesses preferred that increased Class I costs be paid through over-order premiums that are not shared with the market. (Transcript, pp. 586, 860, 923, 939, 985-986, 1274) This is obvious short-term self-interest: this gives the distributing plant greater short-term control over its immediate supply, but at the expense of orderly

marketing. While certain load-specific costs should certainly be paid for with over-order premiums, other balancing costs cannot be reliably compensated in this way. Even such successful marketing agencies as were described in testimony are subject to being undermined and losing their ability to recover full costs of balancing, especially in the absence of an adequate underlying Federal order minimum Class I price. Balancing costs associated with meeting minimum pooling standards should be covered by the regulated Class I price; these are the costs established by the record in this proceeding.

B. Class I Butterfat Formula

The current Class I butterfat price mover, adjusted for the newly announced make allowances, is:

(Butter price x 1.2) - $0.1442

This incorporates the butter yield (1.2 lbs. butter per lb. of butterfat) minus the anticipated make allowance ($0.1442/lb. bf).

NMPF proposes the following replacement:

(Butter price x 1.2) – $0.1365

This corresponds exactly to NMPF's proposal for Class I skim milk, adding the same 77¢ per hundredweight, or 0.77¢ per pound, estimated increase in fluid supply costs. Again, this is a conservative estimate; the experience of California's state program has shown the feasibility of a substantially larger premium on Class 1 butterfat, vis-à-vis manufacturing classes. (California price formulas can be found in several items noticed at Transcript, p. 1075)

C. Class II Skim Milk Formula

In its simplest form (see derivation attached to Exhibit 5), the current Class II Skim Price is:

(Nonfat dry milk price x 8.9) - $1.40 + $0.70

= (Nonfat dry milk price x 8.9) - $0.70

This reflects a nonfat dry milk yield (8.9 lbs./cwt.) and the 70¢ Class II differential minus make allowance ($1.40/cwt.)

NMPF proposes the following direct replacement for the Class II skim milk price:

(Nonfat dry milk price x 8.9) – $0.53

NMPF's proposed formula is equal to the full value of nonfat dry milk (NFDM) derived from a hundredweight of skim milk, minus condensing costs, plus the cost of rehydrating powder. This is similar to the current calculation, except that it avoids offsetting duplication of the cost of drying condensed skim milk in the formula.

In the Order Reform Proposed Rule and in the Final Decision, the calculation of the Class II price was based on the Class IV calculation, plus 70¢. (63 FR 4882, 64 FR 16104) "The $0.70 differential represents the cost of converting concentrated milk to dry solids, plus rehydration." (64 FR 16104) "Only a small portion of the $0.70 is intended to represent the cost of rehydration. The majority of the $0.70, $0.57, represents the cost to dry condensed milk…. It should be noted that the cost to purchase or manufacture NFDM for use in Class II products would include not only the cost of milk at the Class IV price, but the cost of making NFDM." (64 FR 16104) The differential between Class II and Class IV prices is intended to represent "the cost of drying condensed milk and re-wetting the solids to be used in Class II products." (64 FR 16104)

This can be expressed mathematically as follows:

Class II skim milk price = Class IV skim milk price + 70¢

= Class IV skim milk price + drying cost + rehydration cost

Recognizing that the Class IV skim milk price is equal to the powder value of skim minus the cost of condensing and drying milk, the formula can also be expressed as:

Class II skim milk price= powder value – condensing cost - drying cost + drying cost + rehydration cost

Or,

Class II skim = powder value – condensing cost + rehydration cost

The fact that condensing costs are included on both sides of the equation cuts to the heart of the matter – *i.e.*, that Class II condensed skim must not be priced any higher than powder plus the cost of rehydrating:

Class II skim + condensing = powder value + rehydration cost

This necessary condition in the pricing formula is noted in the final decision:

> Generally, the source of inputs alternative to product milk for the manufacture of Class II products is dry milk products and butterfat that otherwise would be used in butter. Basing the price of milk used to make Class II products on these alternative ingredients should help considerably to remedy a situation in which it is perceived that a separate product class for dry milk (Class III-A) has resulted in a competitive advantage over producer milk used to produce Class II products. [10]

In other words, the objective of the 70¢ Class II differential is to create a proper balance in the relationship between nonfat dry milk and Class II prices. Currently, this relationship is based upon make allowances established in the late 1990's; it is therefore out of date and will be inconsistent with any update to the manufacturing make

[10] 64 FR 16104.

allowance. The proper course is to establish a direct relationship between the Class II skim milk price and the nonfat dry milk price, with only a negative allowance for condensing and a positive allowance for re-wetting. NMPF's proposal follows the same logic as the current Class II skim milk price formula, but simplifies it by canceling redundant elements.

Class II skim = powder value – condensing cost + rehydration cost

= ***(Nonfat dry milk price x 8.9) – $0.62 + $0.09***

= ***(Nonfat dry milk price x 8.9) – $0.53***

This is exactly the relationship intended at the time of order reform. The proposed formula is a modest update of the formula originally established by order reform in 1998. That original formula, applied in 2000 and 2001, was equivalent to:

Class II skim = (Nonfat dry milk price x 8.8) – $0.51

In addition to restoring the original price relationship, NMPF's proposal would simplify the formula, make it easier to understand, and make regular corrections less necessary. A substantial amount of Class II skim milk is sold as skim condensed milk, which competes with nonfat dry milk as an ingredient. Substitution between Class II skim condensed and nonfat dry milk can help balance markets, but the margin must be set so that permanent year-round or otherwise uneconomic substitution of nonfat dry milk for skim condensed does not occur. To accomplish this, NMPF's formula is equal to the value of an equivalent volume of nonfat dry milk, minus a condensing cost, plus the cost of rehydrating powder.

NMPF conducted a panel survey[11] of six dairy processors who condense and sell skim milk. This panel estimated direct costs of condensing skim milk at between 6¢ and 7½¢ per pound of solids, slightly higher than the conventional range of 6¢ to 7¢ range due to the current high energy prices. That these numbers are reasonable was confirmed by at least two witnesses. (Transcript, pp. 436, 636) The panel estimated the cost of rehydration at 1¢ to 1½¢ per pound of solids. Conservatively applying the 7½¢ for condensing minus 1½¢ for rehydration results in a deduction of 53½¢ per cwt. of skim milk, nearly identical to the relationship defined at the time of order reform.

It was also the consensus opinion of the panel that the relationship between powder price and Class II skim prices, as it existed prior to the application of the Make Allowance Decision, reflected a good balance, and that the pre-make allowance hearing gap should be neither raised nor lowered. The Class II skim price in 2006 was equivalent to:

Class II skim = (Nonfat dry milk price x 8.9) – $0.5474

NMPF's proposed formula restores this effective balance between the use of Class II skim condensed milk and its occasional appropriate substitution with nonfat dry milk. Thus, NMPF's proposal is, once again, based on sound Federal order principles.

D. Class II Butterfat Formula

The current Class II butterfat price is calculated as:

(Butter price x 1.2) - $0.1442 + $0.007

[11] In a panel survey, a group of experts discuss and attempt to arrive at consensus on technical or economic matters, for example, in this case, processing costs. A panel survey is useful because it can obtain useful information based on several and varied opinion, and does not require individual participants to reveal confidential data.

= *(Butter price x 1.2) - $0.1372*

This incorporates the butter yield (1.2 lbs./lb. of bf) minus the make allowance ($0.1442/lb. bf), plus the Class II differential ($0.007/lb. bf).

NMPF proposes the following replacement:

(Butter price x 1.2) – $0.1215

This is equivalent to the proposed Class I butterfat mover, plus the minimum Class I differential of 1.6¢/lb. ($1.60 per cwt.) That is, it sets the Class II butterfat price equal to the minimum Class I butterfat price, without applying any location differential, so that it is uniform across the country.

The average 2005 butterfat tests for Class I use and Class II use were 1.97% and 7.42%, respectively. Their combined average butterfat test was 3.34%, close to the Federal order standard of 3.5%. Class I and II supplies are complementary, with much Class II butterfat use coming from the surplus butterfat at Class I bottling plants. In the 1994 Class II pricing decision that helped define current Federal order principles regarding Class II pricing, USDA concluded that "[t]his decision makes a clear break from the past in that Class II milk pricing will function in a manner consistent with Class I pricing largely in recognition of the similarity of the distribution and marketing channels shared by milk used in both classes." (59 FR 64524, et seq.) That is, Class II milk pricing should and would approximate Class I pricing, except for the potential substitution of nonfat dry milk powder in Class II uses.

Class II butterfat, however, is not constrained by competition with a manufactured substitute. Class IV and Class III butterfat can be used to produce butter, butteroil,

plastic cream, and anhydrous milkfat. Under normal conditions, these are not viable economic substitutes for cream in Class II applications.

As NMPF's witness testified, the clearest evidence of this can be found in the market's reaction to the California price and pooling system. The butterfat price formulas for California Class 2 and 3 (equivalent to Federal order Class II) are 3.7¢ to 3.93¢ higher than the butterfat formula for California Class 4A (equivalent to Federal order Class IV). If substantial substitution of butter, butteroil, or anhydrous milkfat for cream has not occurred in California, where the gap is nearly 4¢, there is no reason to expect such substitution in the Federal order system if the gap is set just above 2¢, as NMPF proposes.[12]

Testimony of both the supporters and opponents of Proposal 4 bore this out. Tom Pittman of Southeast Milk, Inc., testified, based on his 12 years of experience working for two large ice cream companies, that the use of Class IV butterfat products such as anhydrous milkfat, butter, and butteroil was impractical, because it was difficult to work with and of unpredictable product quality. (Transcript, pp. 408-409, 428)

Witnesses for Dean Foods and Nestlè both testified in opposition to Proposal 4. Each argued that Class II processors might seek to use Class IV butterfat products in place of Class II cream if the gap grew too large; but neither could confirm that they, or anyone else, actually does so. Each admitted that processors exploited much larger gaps that arise periodically between the California Class 2 and 3 and Federal order Class II butterfat prices by moving cream between the two systems; but again, neither would state when questioned that they or anyone else exploits the permanent gap between Class 4a

[12] As noted in Exhibit 5 (footnote on p. 18), the California milk price formulas were on the website of the California Department of Food and Agriculture, as of December 7, 2006, at http://dairy.ca.gov/pdf/Steps_for_calc_minprices.pdf

and Class 2 and 3 butterfat prices in the California system. (Transcript, pp. 862, 864, 1018, 1025-1026)

Another witness argued that a 2¢ increase in the Class II butterfat price could lead to substitution of Class IV butterfat products for Class II butterfat. However, his testimony was based on the situation that existed in 1998 when U.S. butter and butterfat prices rose as much as two dollars above the world price, creating an opportunity to buy imported Class IV-type butterfat products for as much a dollar a pound below domestic prices. Those circumstances are hardly comparable to a 1½¢ increase in the Class II butterfat price; moreover, he testified that even in 1998, substitution was very limited. (Transcript, pp. 875, 901-902)

Class II skim needs can and should be balanced using nonfat dry milk. Since manufactured butterfat products are not economical tools for balancing Class II butterfat needs, however, they must be satisfied in the same way as Class I milk: through the participation of producers and their cooperatives to maintain pooled reserve surpluses. The reasonable conclusion, based on the 1994 decision and the lack of economic substitutability between Class II cream and manufactured butterfat products, is that Class II butterfat should be priced comparably with Class I butterfat .

However, because some Class II products trade on a national market, the Class II butterfat price should be uniform across the country, and set equal to the minimum Class I butterfat price. This will avoid creating regional disparities among the manufacturers of such products.

E. Clarification of Economic Impacts

Static analysis shows that NMPF's proposed changes would increase the Class I price by 77¢, the Class II skim milk price by 17¢, and the Class II butterfat price by 1.57¢. (Exhibit 5, p. 19) This would result in positive impacts on the blend price in all markets.

The witness for Nestlè offered very selective summary results of market research that company had done on two categories of drinks. She testified as to retail elasticity estimates Nestle had made, but offered no other detail. She alleged that the elasticity for Nestlè's flavored 13.5-ounce "Nesquik" single serve drinks is -1.35, meaning that sales drop 1.35% for every 1% increase in the retail price.(Exhibit 33, p. 4) The retail price discussed in the witness' cross examination was $1.79. (Transcript p. 858, et seq.)

Although the selective nature of the Nestle testimony makes it dubious, it does nothing to undercut NMPF proposal. To put Nestlè's alleged elasticities into perspective, a hundred pounds of milk is equivalent to more than 64 13.5-ounce single-serve "Nesquik" containers, so the retail price of this product is $114.56 per hundredweight. The 77¢ Class I price increase proposed by NMPF is equal to 0.67% of this retail value. Multiplied by the retail demand elasticity asserted by the witness, if this increase were passed along to the retail consumer, a roughly 5% increase in the Class I price would reduce the demand for this product by 0.9%. This translates into a derived demand elasticity for the raw milk of about -0.15; this is a very inelastic demand.

The results for Nestlè's half-gallon flavored milk is similar in magnitude: if the retail price is $4.19 per half gallon, then it is $56.57 per hundredweight. The proposed 77¢ increase is 1.36% of the retail value; this increase would reduce retail demand by

2%. So a 5% increase in the Class I price reduces demand by 2%. This gives a derived demand elasticity of about -0.4, another very inelastic demand.

Furthermore, if – as observed by the USDA examiner – Nestlè tends to offer promotional prices for these products when other milk prices are high, and increase prices when other milk prices are low, measured elasticities could be increased by the opposite price movement of these competing milk products. This would seriously distort the products' demand elasticity.

Finally, if the demand for these products was assessed in isolation, as is the common practice in this type of study;, the results overstate the impact on milk demand. It is well known that when sales are lost in an individual category of milk product because the price of that product alone is increased , some of those lost sales are recaptured by other milk categories. If the price is raised for all milk, the demand elasticity will be even smaller than the figures cited by the witness for Nestlè.

USDA's dynamic analysis projects an average annual positive impact on producer revenue of nearly $200 million over the first two years, and nearly $150 million over 9 years. Based on USDA's projected Class price impacts, the blend price would be increased in all markets for at least the first two years.

Econometric models necessarily depend upon past data to project the future, and so assume no change in the underlying market structure. But there is a general consensus among professional observers of the dairy market that the US dairy market is becoming, and will continue to become, more tied to world markets. This means that changes like the NMPF proposals will have a smaller impact on U.S. cheese, butter, and powder

prices; this is because the world market is larger than the U.S. market alone, so the impact is spread thinner. For this reason, NMPF believes that the positive impacts of its proposals on producer revenue will be larger than USDA projects, and that they will be positive in all Federal order markets indefinitely. (Exhibit 5, p. 20)

In all other respects, however, USDA's econometric model appears to be a very effective representation of the past ten years. The documentation of the model, provided for the record, was both straightforward and complete. Attempts at the hearing to find fault with USDA's model and its results were notably ineffective .

In particular, Dr. Gould of the University of Wisconsin criticized both USDA's model and its results, and offered his own analysis as an alternative, which purported to show that NMPF's proposed changes would not increase prices for producers as USDA's analysis said it would.. However, under cross-examination, Dr. Gould admitted that his analysis had not separated the impacts of NMPF's Class I and II price proposals from those that had been caused by the Make Allowance Decision. At first, Dr. Gould declined to testify what his model showed with respect to NMPF's proposal alone; however, after he was specifically told by the hearing officer that he wanted to know that information, Dr. Gould separated the effects and his analysis showed that all markets would experience price increases as a result of NMPF's proposal, including an 18¢ increase in the Upper Midwest. (Exhibit 26; Transcript pp. 540-541)

Dr. Gould also attempted to challenge the adequacy of USDA's model to address dynamic impacts by arguing that the price elasticity of supply for U.S. milk production used in the USDA model (by Dr. Gould's calculation,. 0.027) was far out of line with price elasticities that had been reported over the past 20 years in peer-reviewed journals .

The next morning, however, a somewhat chagrined Dr. Gould corrected his testimony, admitting that he had made a simple error of arithmetic and had miscalculated the elasticity in USDA's model by a factor of 10 – that it was actually 0.269, and not 0.027. [13] Dr. Gould admitted that USDA's actual estimate of elasticity was "reasonable", and fell well within the range of historical estimates that he had presented on the previous day. (Exhibit 26; Transcript p 512)

Ronald Knutson, testifying on behalf of IDFA argued that the same "extensive economic analysis" that was applied to the Class I price calculations at the time of order reform should be applied here. (Transcript, p. 1128) In fact, the proposals at hand are based upon more "extensive analysis" than the corresponding current provisions. The most "extensive economic analysis" incorporated into the calculation of the Class I price formulas at the time of order reform addressed Class I location differentials, which are not addressed in this proceeding, and specifically did not address the absolute level of Class I (or Class II) prices, which are addressed in this proceeding.

Dr. Knutson specifically called for a replication of a Class I location value study that was conducted by Cornell economists in preparation for the 1998 proposed rule. (Transcript, p. 1149) In fact, this study did not bear on absolute Class I values, only on relative values by location, as Dr. Knutson admitted. (Transcript, pp. 1162-1163) This does not bear on the issues in this proceeding.

[13] Ironically, Dr. Gould also testified that he was regarded as a "perfectionist" among his colleagues on the faculty at the University of Wisconsin.

F. Class I/II Prices are not Currently Linked to Class III/IV Prices

Opponents of NMPF's position have argued that there is some necessary and sacrosanct relationship between Class prices that must be strictly retained; and that NMPF is attempting to "decouple" Class I /Class II prices from Class III/IV prices. This argument is a canard. Even under the current system, Class I/II prices are not linked to Class III/IV prices for the same period. Under the current system, Class I/II prices are announced in advance of the month in which they must be paid, and are based on product price data obtained from the first two weeks of the previous month. Class III/IV prices, on the other hand, are not announced until the end of the month to which they are applied, and are based on data collected during that month. Thus, Class I/II prices for a given month are based on market prices that are, on average, five weeks older than the prices on which Class III/IV prices are calculated.[14] (7 CFR 1000.50)

The Class II butterfat price already has a distinct formula that does not reference the Class III and IV butterfat price. (7 CFR 1000.50) As discussed at length above, the Class II skim milk price was unnecessarily tied to the Class IV skim milk price as a convenient means of relating it to the nonfat dry milk price.

There is also no inherent price relationship between the Class III/IV prices and Class I prices. Again, the relationship is merely formal and based on decisions made during order reform. That decision dictated that Class I milk prices are based on the "higher of" an advanced Class IV butter-powder value or an advanced Class III cheese-whey value, plus the Class I differential. Thus, Class I prices are not strictly tied to either

[14] For example, the March 2006 Class I and II advanced prices was be announced on February 17, using prices paid during January 28 through February 10; the Class III and IV prices for March 2006 was announced on March 31, using prices paid during February 25 through March 24. The advanced prices are, in effect, five weeks older than the Class III and IV price.

the Class III formula or the Class IV formula. (7 CFR 1000.50) The purpose in this was to minimize the likelihood that the Class I price would fall below the Class III or IV prices. (64 Fed. Reg. 16101, *et seq*.) This same objective can be achieved by implementing the proposals offered by NMPF: a larger positive difference between the underlying calculations of the Class I price and of the Class III and IV prices makes a negative difference in the result of the calculation less likely in any given month.

G. Regarding the Value of Option 1A as Precedent

In his prepared statement, Dr. Yonkers, the witness for IDFA, stated,

> It was only by an act of Congress, not the careful and deliberate analysis conducted over a three year period by USDA that forced the dairy industry to adopt modified Option 1A with a minimum Class I differential of $1.60.
>
> USDA is under no obligation to assess Class I differentials now using an approach that USDA rejected in both 1998 and 1999…. Congress never endorsed, much less imposed, a specific methodology for determining Class I differentials. (Exhibit 45, p. 23-24. Emphasis added.)

Dr. Yonkers is incorrect both factually and legally.

The Secretary narrowed the Class I pricing options down to two fully developed options in a proposed decision. (63 FR 4802, et seq.) A subsequent recommended decision went into considerable detail on the pro's and con's of both Options, concluded that each had certain advantages with respect to the objectives of the Act, and finally recommended Option 1B over Option 1A. (64 FR 16026 et seq.)

On November 29, 1999, an Act of Congress was signed by the President mandating that the Secretary "shall price fluid or Class I milk under the Federal milk marketing orders using the Class I price differential identified as Option 1A 'Location-Specific Differentials Analysis' in the proposed rule published in the Federal Register on

January 30, 1998 (63 Fed. Reg. 4802, 4809), except that the Secretary shall include the correction and modifications to such Class I differentials made by the Secretary through April 2, 1999." (7 USC 7253 (d) (2))

Under U.S. law, Congress is always presumed to know what it is doing when it passes a statute. Goodyear Atomic Corp. v. Miller, 486 U.S. 174 (1988). Moreover, this particular legislation not only cited the proposed rule as the source for the differentials, it specifically cited the description and justification of Option 1A, beginning on 63 FR 4809. Congress was fully informed by the published decisions of the Secretary, including the justifications and methodologies for Option 1A. As such, the basis on which USDA developed Option 1A, ultimately mandated by Congress, signed by the President, and adopted by the USDA, must serve as a meaningful precedent in the present proceeding.

H. Class I and II Formula Provisions Should not Incorporate Class III and IV Price Formulas by Reference

While elements of the Class III and IV milk price formulas may continue to be necessary bases for defining the Class I and II price formulas, their direct incorporation into the Class I and II price formulas can lead, and has led, to changes to Class I and II prices without due consideration for the independent conditions that pertain to Class I and II milk supplies. Establishing distinct and simplified Class I and II formulas will help ensure that future changes in the Class I and II prices are based upon direct consideration of cost and processing considerations for both fluid milk (Class I and II) and

manufacturing milk (Class III and IV). This would avoid unintended distortions in the relationships among Class prices that might lead to disorderly marketing conditions.

I. Responses to Other Testimony on General Issues

The proposals in this hearing make use of milk cost of production data to adjust certain Grade A-specific producer costs. It is not a general proposal to set milk prices based on the cost of production.

Contrary to the assertions of the witness for Kraft, the proposals in this proceeding make no changes in the nature of the Federal order program, and have no impact on United States' obligations within the World Trade Organization. (Transcript 930-932)

Conclusion

The Make Allowance Decision was intended to recognize increased processing costs for cheese, dry whey, butter, and nonfat dry milk, but will reduce the price that dairy producers receive for all four classes of Federal order milk. Despite the fact that the Make Allowance Decision will lower Class I and Class II prices, the Class I and II milk supply costs, which are incorporated into the current Class I and II price formulas, will not be updated. Dairy producers will lose revenues to compensate for processors'

increased costs, but will not be compensated for their own, and highly comparable, increased costs of supplying Class I and Class II milk..

NMPF urges the Secretary to issue, on an expedited basis, an amended rule that would establish simplified and updated Class I and II price formulas based on dairy product prices, in order to maintain the proper price relationship among the four classes of milk and dairy products. The hearing record in this proceeding demonstrates both the equity and appropriateness of updating the Class I and II price formulas; and shows that an expedited decision is needed to avoid economic hardship for many of American's dairymen. America's dairy producers will suffer unjustified loss of income – and in some cases, of livelihood -- if the Make Allowance Decision is not followed immediately by a decision recognizing increased Class I and II cost allowances as well. Fair is fair. NMPF therefore urges immediate and expedited attention to the proper determination of Class I and Class II prices and a speedy decision that effectively addresses the substantial and analogous inadequacies in the Class I and II price calculations.

Respectfully submitted,

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National Milk Producers Federation

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