

BEFORE THE SECRETARY OF AGRICULTURE
AGRICULTURAL MARKETING SERVICE

<i>In the matter of:</i>	)	
	)	
Proposed Amendments of Tentative	)	Docket No.
Marketing Agreements and Orders	)	A0-14-A74, <i>et al.</i>
	)	
(Class III/IV Price Make Allowances)	)	DA-06-01
	)	

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 more than 50,000 of America’s estimated 65,000 dairy farmers.

The Agricultural Marketing Service (AMS) of the U.S. Department of Agriculture (“the Department”) initiated this proceeding to consider a proposal submitted by Agri-Mark to change the method of calculating the manufacturing (or “make”) allowances that are employed to determine the prices that producers receive for milk used in the manufacture of Class III and Class IV milk. Agri-Mark seeks these changes because manufacturers have in recent years experienced significant increases in their costs of making certain benchmark Class III and Class IV products. Because of the way that make allowances work in the Federal order system, those manufacturers are constrained from passing on increased costs to the market because any market price increase automatically results in an equivalent increase in the price they have to pay for their milk.

NMPF generally supports Agri-Mark's proposal as it applies to Class III and Class IV products, even though the proposal would result in decreased Class III and Class IV revenues for producer pools,¹ because the proposal fairly responded to cost increases that those manufacturers were incurring but could not recapture through the existing make allowance. NMPF recommends that the proposal be modified in certain respects as it applies to Class III and Class IV milk, in particular that in the future AMS use a cost index to calculate monthly adjustments in energy costs.(Exhibit 58).

However, NMPF opposes the application of the proposed increases in make allowances to calculation of the prices that producers would receive for milk used in Class I and Class II products. NMPF proffered testimony that the use of increased make allowances in calculating Class I and Class II prices would be unjustified for several reasons. First, the increased costs that the proposed adjustments are intended to address are much more characteristic of the costs incurred by manufacturers of Class III and Class IV products, and not as characteristic of costs incurred in the production of Class I and Class II products.(Exhibit 58, pages 3-5). Second, unlike manufacturers of Class II or Class IV products, Class I and Class II are not constrained under the Federal order system rules from recovering additional costs by raising market prices. Class I and Class II handlers are able to pass on increased costs to the market without incurring a concomitant increase in the price they must pay for milk. Finally, in the latest reform of Federal orders the USDA defined the relationships between the Class I and II prices and the Class III and IV prices largely on the basis of costs that vary with manufacturing

¹ The negative producer revenue impacts associated with changing the Class III and IV prices are estimated at between \$225 million to \$620 million over a 5-year period, based on the scenarios analyzed by Dr. Howard McDowell, USDA Senior Staff Economist. (Exhibit 2).

costs. As a result, the automatic application of Class III and IV make allowance changes to Class I and II price calculations actually perverts these relationships.

USDA's own economic analysis indicates that the consequence of applying the proposed adjustment to Class I and Class II milk prices would be to take an estimated \$150 million out of the pockets of America's dairy farmers in the first year, and perhaps as much as \$350 million over five years. This would create an unwarranted windfall of those same amounts for processing companies. NMPF, therefore, proffered testimony that an appropriate modification to the proposal would be to maintain the current data and calculation methodology for determining Class I and Class II milk prices, and to apply the proposed changes in the calculation of make allowances only in determining Class III and Class IV milk prices. (Exhibit 58).

Despite explicit wording in the Federal Register notice inviting interested parties to submit evidence on "any appropriate modification" of the proposal, the Administrative Law Judge excluded NMPF's testimony of a recommended modification on grounds that it was allegedly outside the scope of the hearing.² NMPF respectfully submits that the Administrative Law Judge erred in making this ruling because: (1) NMPF's testimony suggested a possible modification to Agri-Mark's proposal, and evidence of "any appropriate modification" was expressly solicited by AMS in the hearing notice; (2) NMPF testimony regarding an appropriate modification to the Agri-Mark is proper evidence in this proceeding because the proposed modification is a "logical outgrowth" of the initial proposal; (3) the exclusion of evidence of a recommended alternative course of action is not the proper remedy in this rulemaking; and (4) the ruling effectively

² NMPF's representative specifically identified its recommendation in this regard as "an eminently appropriate modification to the proposal, as discussed in the preamble." See Hearing Tr. [Jan. 27] at 49.

deprives 50,000 U.S. dairy farmers of their right to be heard in this proceeding and to protect their interests in as much as \$350 million in future revenue. NMPF asserts that the ruling to exclude was clearly in error and must be vacated; and that NMPF's proffered testimony must be accepted into the record of this proceeding.

1. NMPF's Proffered Testimony was Incorrectly Excluded.

A. The Hearing Notice Defined the Scope of the Hearing to Include Discussion of the Agri-Mark Proposal and "Any Appropriate Modifications Thereof."

Parties opposed to NMPF's position in this proceeding urged the Administrative Law Judge to rule that NMPF's testimony suggesting a modification of the Agri-Mark proposal was outside the scope of the hearing despite the fact that the plain language of the hearing notice anticipated evidence with respect to possible modifications:

The purpose of the hearing is to receive evidence with respect to the economic and marketing conditions which related to the proposed amendments, hereinafter set forth, and any appropriate modifications thereof, to the tentative marketing agreements and to the orders.

71 Fed.Reg. 545-552 (Jan. 5, 2006) (emphasis added). Thus AMS's notice, on its face, invited interested parties to submit evidence of any modifications that might be appropriate in light of the potential economic consequences of the proposal. No words could be clearer. And yet, in the lengthy colloquies on this issue, NMPF's opposition never even discussed this provision of the notice and it was never explained how NMPF's testimony was inappropriate in light of AMS's solicitation of evidence regarding potential modifications of the proposal.³

³ Hearing Tr. (Jan.27, 2006) at 7-43.

B. NMPF's Testimony that was Improperly Excluded was Evidence regarding an "Appropriate Modification" to the Agri-Mark Proposal.

NMPF responded precisely to AMS's statement of purpose by preparing and proffering testimony that addressed the economic and marketing conditions that related to Agri-Mark's proposal to increase the make allowances for Class III and IV, and that suggested appropriate modifications to that proposal in light of the likely economic consequences. Dr. Roger Cryan, NMPF's Director of Economic Analysis and designated witness in this proceeding, testified that the justification for Class III and Class IV make allowances arises from particular costs that are incurred by manufacturers of certain benchmark dairy products; that the best and fairest way to compensate those manufacturers would be to establish make allowances for only those products, but that was impractical and so make allowances were applied to all Class III and Class IV milk; that in recent years manufacturers of the benchmark products have incurred increased costs, particularly fluctuating costs of energy; and that those increased costs had rendered the current make allowances out-of-date as they applied to Class III and Class IV products. (Exhibit 58).

Dr. Cryan also proffered testimony that Agri-Mark's proposal, if accepted without appropriate modification, would have adverse economic consequences for dairy producers that were not justified by the need to increase make allowances for manufacturers of the benchmark Class III and Class IV products. He noted that under the current methodology employed in Federal milk marketing orders, Class I and Class II prices are calculated using the Class III and Class IV price formulas by reference. As a

result, if Agri-Mark's proposal were accepted without appropriate modification, bottlers and manufacturers of Class I and Class II products would receive the benefits of the increased make allowances even though they had not incurred the additional costs that justified the adjustments under consideration. (Exhibit 58) As a result, dairy producers could lose as much as \$350 million over a five-year period (Exhibit 2), and manufacturers of Class I and Class II products would obtain an unjustified windfall of the same amount. Dr. Cryan proffered testimony that the appropriate adjustment to the proposal would be to continue to maintain the status quo in calculating the prices that producers receive for milk used in Class I and Class II – *i.e.*, not to change the current data or methodology for calculating those prices and to continue to use current make allowances in those calculations– and to apply the proposed changes for make allowance only to the calculation of the prices that producers would receive for milk used in the manufacture of Class III and Class IV products. (Exhibit 58).

C. Even Though the Hearing Notice Called for Evidence of “Any Appropriate Modification” of the Agri-Mark Proposal, the Administrative Law Judge Excluded Such Evidence.

The Administrative Law Judge's ruling to exclude portions of NMPF's testimony is plainly at odds with the hearing notice in this proceeding. The Administrative Law Judge's ruling was misguided and incorrect for a number of reasons. First, there is no basis whatsoever for a motion to exclude evidence that is clearly and expressly permitted by the plain terms of the hearing notice. How can evidence regarding “any appropriate

modification” of the proposal under consideration be specifically requested in the hearing notice and then be excluded at the hearing as outside the scope of the proceeding?⁴

Second, the Administrative Law Judge’s rationale for excluding NMPF’s evidence was inherently illogical. The Administrative Law Judge stated that the evidence could not be received because it had not been considered by the Department of Agriculture in its “prehearing process.” This makes no sense. The Department’s prehearing analysis is simply its own preparation for the hearing, has no formal or legal status of any sort, and in no way operates to define the scope of the hearing. The Department is not obliged to present a prehearing analysis, and in many instances, does not. Moreover, the Department’s preparatory analysis was published in the hearing notice. Therefore, “any appropriate modification” that might be suggested by an interested party would necessarily be something that the Department had not fully analyzed up to that point. By making this ruling, the Administrative Law Judge

⁴ When he ruled on motions to exclude NMPF testimony, the Administrative Law Judge stated inexplicitly:

At issue ... is whether a modification of the proposal should be entertained. It has been objected to as being beyond the scope and parameters of the notice. The modification contained in the statement which has been tendered as Exhibit 58 would apply the adjustment to the make allowance only to Class III and Class IV milk, arguing that the products are affected are Class III and Class IV.

Prior to this hearing the analysis of the proposal that was done by the Department of Agriculture as part of the prehearing process clearly did not consider the impact of such a modification. And indeed, the notice contains the language that I exchanged with Mr. English. The argument of counsel further highlights the problems injection of such a modification might precipitate.

I further note that this proposal, which was noticed as being heard on an expedited basis, and that many witnesses have attested to, that a decision at the earliest possible date is critical to their continued existence.

Due to the significant financial impact which will likely follow any adjustment, consideration of a modification which has not been subjected to a thorough and deliberate analysis, I think, is unwarranted. For that reason, I’m going to sustain the objection at this time.

effectively read the phrase “any appropriate modification” out of the hearing notice, in contravention of basic administrative law principles. *See Alto Dairy v. Veneman*, 336 F.3d 560, 569 (7th Cir. 2003).

Third, if the Administrative Law Judge was concerned, as he stated he was, that the modification suggested by NMPF had not been considered by the Department of Agriculture in its prehearing process, it pointed, if anything, to a problem with the level of analysis in the record, not with NMPF’s proffer of evidence. NMPF’s evidence was to propose a modification that would avoid very significant and unjustified losses of revenue for dairy producers. Those losses have been estimated in USDA’s prehearing analysis to be potentially as high as \$350 million, (Exhibit 2, Table A-4, summing all impacts on Class I and II revenue). This would constitute an unwarranted windfall to processors of Class I and Class II products of the same amount. (Exhibit 58). USDA was certainly aware that the proposed “changes in [pricing] formulas would also affect the prices of Class I and Class II milk pooled on Federal milk marketing orders.” 71 Fed.Reg. at 546. (Jan. 5, 2006). Although USDA had made an estimate of the economic effects, it made provided no analysis about whether they were justified.

NMPF was entirely within its rights, particularly in light of the language of the hearing notice, to submit evidence into the record regarding the economic effects of the Agri-Mark proposal on dairy producers generally, and to suggest a modification of that proposal that would appropriately avoid an unintended and unjust consequence. The Administrative Law Judge’s decision – to exclude this important evidence just because USDA had not published a more thorough analysis of the Class I and Class II impacts of

the proposal – flies in the face of common sense and basic principles of fairness and good administrative practice.

2. NMPF Testimony Regarding Modification of the Agri-Mark Proposal was Proper Because it was a “Logical Outgrowth” of the Initial Proposal.

Because AMS’s notice solicited evidence regarding “any appropriate modification” of the published proposal, the Administrative Law Judge’s ruling to exclude must be vacated and NMPF’s full testimony admitted in this proceeding. But, even putting aside the clear language of the notice itself, NMPF’s testimony was properly admissible under recognized principles of federal administrative law and should never have been excluded.

AMS was not limited, contrary to what Administrative Law Judge was misled to believe, to either accepting or rejecting the rule as originally proposed and published for comment. In *Alto Dairy*, a recent case that involved exactly the same type of hearing to amend a Federal milk marketing order, Judge Posner stated:

The purpose of a rulemaking proceeding is not merely to vote up or down the specific proposals advanced before the proceeding begins, but to refine, modify and supplement the proposals in light of evidence and arguments presented in the course of proceedings.

Alto Dairy v. Veneman, 336 F.3d 560, 569 (7th Cir. 2003); *See also Arizona Public Service Co. v. EPA*, 211 F.3d 1280 (D.C. Cir.), *cert. denied*, 532 U.S. 1970 (2000).⁵ A long line of authority establishes that an agency may adopt a final rule that is different from the proposed rule if that final rule is a “logical outgrowth” of the proposed rule,

⁵ This principle is applied in all areas of administrative rulemaking. “There is no question that an agency may promulgate a final rule that differs in some particulars from its proposal. Otherwise, the agency ‘can learn from the comments on its proposal only at the peril of starting a new procedural round of commentary.’” *Chocolate Manufacturers Ass’n, supra*, 755 F.2d at 1104-04, *citing, International Harvester Co. v. Ruckelshaus*, 478 F.2d 615, 632 n. 51 (D.C. Cir. 1973).

Omnipoint Corp. v. FCC, 78 F.3d 620, 631-32 (D.C.Cir. 1996); *Solite Corp. v. EPA*, 952 F.2d 473, 484-85 (D.C.Cir. 1991); *Fertilizer Inst. v. EPA*, 935 F.2d 1303, 1311 (D.C. Cir. 1991); *Small Refiner Lead Phase-Down Task Force v. EPA*, 705 F.2d 506, 546-47 (D.C.Cir.1983). The final rule “need not match the rule proposed [and] indeed must not if the record demands a change.” *Korritzky v. Reich*, 17 F.3d 1509, 1513 (D.C.Cir. 1994); *Northwest Mining Ass’n v. Babbitt*, 5 F.Supp 2d 9, 13 (D.D.C. 1998).

The threshold inquiry in applying the “logical outgrowth” test is whether the agency, in its proceeding notice, “alerted interested parties to the possibility of the agency’s adopting a rule different than the one proposed.” *Sprint Corp. v. FCC*, 315 F. 3d 369 (D.C. Cir. 2003). In this case, there can be no doubt that all interested parties were placed on the requisite notice that the agency would consider possible modifications to the proposal under consideration. Indeed, AMS specifically requested evidence on “any appropriate modification” to the published proposal, and this was entirely proper because the validity of an agency’s notice is “tested by exposure to diverse public comment...” *Building Industry Ass’n of Superior California v. Babbitt*, 979 F.Supp. 893, 901 (D.D.C. 1997) citing *Small Refiners, supra*, 705 F.2d at 547.

An alternative formulation of “logical outgrowth” test is whether interested parties “should have anticipated” that the suggested modification to the initial proposal might be considered and adopted. *Arizona Public Service Co. v. EPA*, 211 F. 3d 1280 (D.C. Cir 2000). As several courts have stated, “a final rule is considered to be the logical outgrowth of a proposed rule if at least the ‘germ’ of the outcome is found in the original proposal.” *National Ass’n of Psychiatric Health Systems v. Shalala*, 120 F.Supp. 2d 33,

39 (D.D.C. 2000), *citing, Nat. Res. Defense Council v. Thomas*, 858 F.2d 1224, 1242 (D.C.Cir. 1998). Again, there can be no question that interested parties could and should have anticipated NMPF’s suggested modification of Agri-Mark’s proposal. In the “preliminary analysis” section of the notice, USDA stated that

...while the proposal seeks to amend the product pricing formulas used to price Class III or Class IV milk pooled under Federal milk marketing orders, changes in these formulas also would affect the prices of Class I and Class II milk pooled on Federal milk marketing orders.⁶

There is much more than a “germ” here. The implication of this statement is, or should be, apparent to anyone familiar with Federal milk marketing orders. If AMS were to accept the proposal made by Agri-Mark to change the make allowances for Class III and Class IV products without any modifications, it would mean that it would also be making changes in the pricing for Class I and Class II products. Of course, the purpose of Agri-Mark’s proposal to change the make allowance formula was to recognize the additional costs that manufacturers of those products were being required to absorb, but cannot pass on through the market. But manufacturers of Class I and Class II products are not so constrained. Thus, Agri-Mark’s proposal also had a potential unintended result – by changing the make allowances for Class III and Class IV, the proposal would also

⁶ The Administrative Law Judge was apparently swayed by the argument that AMS’s notice, by mentioning that proposed changes would also affect the price of Class I and Class II milk, allegedly “went out of its way to tell us that Class I and Class II were not an issue.” See Hearing Tr. (Jan.27, 2006) at 32-33. There is no basis for reading this sentence as operating somehow to exclude consideration of the effects of the proposal on Class I and Class II prices, and the Judge should have rejected this argument for several reasons. First, AMS’s notice expressly states that the scope of the hearing involved “any appropriate modification” and the term “any” when used in a legal document “is generally used in the sense of ‘all’ or ‘every’ and so its meaning is most comprehensive.” *Fleck v. KDI Sylvan Pools, Inc.*, 981 F.2d 107, 115 (3d Cir. 1992). Second, nowhere does the notice specifically say that this issue would be excluded from consideration if a modification were recommended and so the Judge had to infer exclusion. This is not a correct reading because inferences of exceptions or exclusions are not favored in construing legal texts. *Shook v. District of Columbia Financial Responsibility and Management Assistance Auth.*, 954 F. Supp. 416 (D.D.C. 1997) *aff’d in part, rev’d in part*, 132 F.3d 775 (D.C.Cir. 1998)

lower the Class I and Class II prices producers received, even though there was no justification for doing so. (Exhibit 58, pages 3-5).

3. Exclusion of Evidence of a Modification to the Initial Proposal was not the Proper Remedy in this Proceeding

Whatever AMS ultimately decides as a result of this proceeding, there is no basis for excluding highly relevant evidence with respect to the economic impact of the Agri-Mark proposal, or to potential modifications that might improve that proposal. As the D.C. Circuit noted, in a leading case in this area of law, taking evidence with respect to modifications of a proposed rule is a healthy and encouraged process because otherwise an agency “can learn from the comments on its proposal only at the peril of starting a new procedural round of commentary.” *International Harvester Co. v. Ruckelshaus*, 478 F.2d 615, 632 n. 51 (D.C. Cir. 1973).

The courts have criticized and typically set aside administrative determinations where an agency has ignored relevant factors or where its action amounts to an “artificial narrowing of options’ [which] is antithetical to reasoned decisionmaking” *International Ladies' Garment Workers' Union v. Donovan*, 232 U.S. App. D.C. 309, 722 F.2d 795, 817 (D.C. Cir. 1983) quoting *Pillai v. Civil Aeronautics Bd.*, 158 U.S. App. D.C. 239, 485 F.2d 1018, 1027 (D.C. Cir. 1973) (internal citation omitted), cert. denied, 469 U.S. 820, 83 L. Ed. 2d 39, 105 S. Ct. 93 (1984). Agency actions cannot be sustained where the agency has failed to consider significant alternatives. See *ILGWU*, *supra*, 722 F.2d at 815-16 (agency failed to consider “substantial testimony” and “specific proposals” for alternative actions). Similarly, an action will not be upheld where

the agency has intentionally omitted evidence from consideration or where there is nothing in the record to support the agency's decision. See *Pillai, supra*, 485 F.2d at 1027; *California Hosp. Ass'n v. Schweiker*, 559 F. Supp. 110 (C.D. Cal. 1982) (in drafting documents supporting a proposal, agency intentionally omitted facts which undermined its position), *aff'd*, 705 F.2d 466 (9th Cir. 1983). See generally, *Mount Diablo Hosp. v. Shalala*, 3 F.3d 1226, 1232 (9th Cir. 1993).

Unfortunately, the Administrative Law Judge was misled into excluding NMPF's proffered testimony by suggestions of parties opposing NMPF's testimony that exclusion was somehow required by *Chocolate Manufacturers Ass'n v. Block*, 755 F.2d 1098 (4th Cir. 1985), a case that is entirely different in its facts and that does not support, much less compel, the ruling to exclude evidence in this case.⁷

⁷ Neither *Chocolate Manufacturers Ass'n* nor 4th Circuit law supported a motion to exclude evidence in this case. First, even a summary reading of *Chocolate Manufacturers Ass'n* reveals that the issue of excluding evidence in the rulemaking proceeding was never even presented.

The decision in *Chocolate Manufacturers Ass'n* turned on the fact that in its final rule USDA deleted flavored milk from the WIC program even though the proposal under review in that case consisted of 12 pages of detailed factors that would be discussed and 8 pages of listings of specific food nutrition labeling, but never once discussed "flavored milk." In contrast, the proposal in this case asked specifically for the submission of evidence to comment on a proposal to make adjustments to make allowance and the economic impacts of such a proposal, and indicated that it would entertain evidence regarding "any appropriate modifications" of that proposal. While the final rule in *Chocolate Manufacturers Ass'n* may not have been a "logical" outgrowth of the initial proposal, NMPF's recommended modification of the proposal in this case certainly was.

Even if the instant case were factually similar to *Chocolate Manufacturers Ass'n* -- and it clearly is not -- exclusion of evidence would not have been the proper remedy. Indeed, the Fourth Circuit Court of Appeals ruled in that case, not that evidence should have been excluded, but rather that the agency "had to reopen the comment period and thereby afford interested parties a fair opportunity to comment on the proposed changes in the rule." 755 F.2d at 1107.

Finally, suggestion by counsel that 4th Circuit law on this issue is any different from the laws of the other Federal Circuits on this issue is incorrect. The court in *Chocolate Manufacturers Ass'n* expressly recognized and followed the rule announced in *International Harvester Co. v. Ruckelshaus*, 478 F.2d 615, 632 n. 51 (D.C. Cir. 1973) that "an agency may promulgate a final rule that differs in some particulars from its proposal." 755 F.2d at 1103-04.

4. The Ruling to Exclude Portions of NMPF's Testimony Severely Prejudices the Interests of America's Dairy Farmers.

NMPF is an association that represents the majority of dairy cooperatives in the United States and their members. It is the voice of more than 50,000 of America's estimated 65,000 dairy farmers. NMPF's testimony was proffered to warn AMS that dairy farmers' annual revenues, in aggregate, will be unnecessarily reduced by hundreds of millions of dollars if the Agri-Mark proposal is accepted without appropriate modification to prevent an unjust windfall to manufacturers of Class I and Class II products. (Exhibit 58, page 5). The Administrative Law Judge's decision to exclude NMPF's testimony in this proceeding deprives these thousands of farmers of their opportunity to be heard on an issue that is of immense and vital economic interest.⁸

⁸ Later in hearing, the Administrative Law Judge apparently started to realize that he had been led to make a ruling that had cut off debate on a vitally important issue in this proceeding.

THE WITNESS [Mr Hollon]: We came to this hearing with a position predicated on the positions outlined in the original National Milk proposal. Since the Department has now ruled that dairy farmers cannot defend a no-change position with regard to the application of the make allowance changes in Class I and II prices....

THE JUDGE: Mr. Hollon, that's not exactly my ruling....

THE WITNESS: Okay, correct me.

THE JUDGE: My ruling was that what was presented was beyond the scope of the notice and, as such, in other words, it was not an issue in this hearing.

....

MR. VETNE: I hesitate to get in the middle of this, but I can empathize with Mr. Hollon.

THE JUDGE: I empathize with Mr. Hollon, too, and I appreciate the fact that, obviously, this is an issue which is very difficult. It's very complex. It has many, many, many – a penny one way or another makes a big difference to a lot of individual farmers.

Not only was NMPF prevented from expressing the views of its members, but so too were representatives of individual cooperatives. When Mr. Elvin Hollon attempted to testify on behalf of Dairyalea and the Dairy Farmers of America, his testimony was interrupted by objections and motions to exclude as well. The ensuing colloquy between the judge, the witness and various lawyers at the hearing demonstrates both the confused nature of the ruling⁹ and the stifling effect that ruling had on healthy and informed debate over the future of federal dairy policy.¹⁰

As the record shows, the interests of America's dairy farmers in this proceeding are extremely substantial. Testimony given by USDA experts indicates that if the proposed make allowances changes are applied to the calculation of the prices producers receive for Class I and II milk, it will double the impact of the change on producer income that would occur if the proposed changes were applied only in calculating the prices of Class III and Class IV milk. Fifty-eight percent of milk pooled in the Federal orders in 2004 was Class I and II milk. (Exhibit 58, page 5). In this proceeding, USDA senior staff

And, above all, I was really very torn about, in other words, stopping the expansion of the issue into what might have been a very profitable discussion. However, I feel constrained that I must follow what the parameters and scope of the notice were.

Hearing Tr. (Jan. 27, 2006) at 275-76.

⁹ When opponents of NMPF's position also attempted to exclude Mr. Hollon's testimony that supported NMPF's views, the Administrative Law Judge made a different ruling:

THE JUDGE: Well, if it's just a statement of policy, then we can accept it at that. The Secretary, in other words, is certainly free to reject that as he sees fit.

Hearing Tr. (Jan. 27, 2006) at 274.

¹⁰ Mr. Hollon clearly expressed the frustration of the producer community at being deprived of the opportunity to recommend a modification to the proposal that would have made it fair to both Class III and Class IV manufacturers and to producers. See Hearing Tr. [Jan. 27] at 271-278.

economist Howard McDowell presented his analysis of the impact on direct producer income of the proposed make allowance changes under several scenarios. In the scenario with the smallest impact, he estimated that the negative impact to producer revenue from changes in the Class I and Class II prices would be \$155 million over five years (2006 through 2010), or 40% of the projected impact from all classes. In his scenario with the largest impact, producers would lose \$340 million in Class I and II income over five years, representing 36% of the total. (Exhibit 2, Tables A2 and A4).¹¹

Most dairy economists predict that U.S. dairy producers are now facing an extended period of low milk prices. Large and unnecessary reductions in Class I and II revenues will stress farm income and, undoubtedly will be disastrous for many producers. According to Dr. McDowell's analysis (Exhibit 2), the impacts will be greatest by far in the first two years after implementation. This is the very period during which analysts are already predicting exceptionally low prices. The true impacts of unnecessarily reducing producer revenues through the unjustified application of make allowance changes to Class I and II would be amplified under such conditions.

¹¹ Dairy producer cooperative associations – and not proprietary manufacturers --produce the majority of the four benchmark products – especially the Class IV butter and nonfat dry milk. According to the report published by USDA and noted by Dr. Cryan during cross-examination [Hearing Tr. (Jan. 27, 2006) at 119], “Cooperatives marketed 71 percent of the Nation's butter, 86 percent of the nonfat dry milk, 40 percent of the natural cheese, ...[and] 52 percent of the dry whey products” in 2002. [Dr. K. Charles Ling. “Marketing Operations of Dairy Cooperatives, 2002”, Research Report 201, USDA Rural Business-Cooperative Service, February 2004. (available at <http://www.rurdev.usda.gov/rbs/pub/RR201.pdf>), quoted from the abstract]

Increased make allowances result in a transfer of income from producers to processors, but in the case of the benchmark products, this is largely a transfer from producers to their own cooperatives. This means that, in aggregate, producer losses in the Class III and IV prices resulting from increased make allowances are largely offset by higher returns to processing.

In contrast, Class I and Class II products are largely manufactured by proprietary companies and only a very small percentage by dairy producer cooperatives. Dr. Ling's study showed that “Cooperatives marketed...7 percent of the packaged fluid milk products, 9 percent of the cottage cheese, 3 per cent of the ice cream, 6 percent of the ice cream mix, 2 percent of the yogurt,...[and] 13 percent of the sour cream.” As a result, the application of increased make allowances to Class I and Class II prices result almost entirely in income transfer from producers to processors without any offset.

5. If NMPF had been Permitted to Testify Fully, it would have Provided Evidence of an Appropriate Modification of the Proposal Under Consideration.

Opponents of NMPF's position went to almost ridiculous lengths to stifle debate on the issue of make allowance adjustments and, in particular, to prevent NMPF from testifying fully at this hearing.¹² The reason for that is clear. The Agri-Mark proposal, which was intended to provide relief for manufacturers of Class III and Class IV products will, if not appropriately modified, have the unintended consequence of taking hundreds of millions of dollars from the pockets of dairy farmers and providing an unjustified windfall of that amount to processors of Class I and Class II products. Had NMPF been permitted to testify fully, it would have demonstrated how that proposal could be adjusted to make it fairer and more responsive to the underlying issues of increased costs of Class III and Class IV production.

A. Agri-Mark's Proposal was Intended to Provide Relief for Class III and IV Handlers

The hearing was requested to provide relief for the makers of certain Class III and IV products, specifically of cheddar cheese, whey, butter, and nonfat dry milk who can no longer recover all of their costs through the current make allowance.¹³ The manufacturing margins built into the current formulas are fixed. Those fixed margins are based on cost

¹² Perhaps the most outrageous example was the attempt by one lawyer to arrogate to himself the authority to edit Dr. Cryan's testimony and to submit that edited version into the record of this proceeding as a substitute for the testimony that Dr. Cryan had offered. Hearing Tr. (Jan.27, 2006) at 15-17. The lawyer was not representing either Dr. Cryan or NMPF and had no right to offer his edited version of the testimony of a witness he did not represent. While a lawyer has the right to object to testimony, he has no right to alter the testimony of an opposing witness and offer it into the record of a proceeding. This was highly improper and should never have been tolerated by the Administrative Law Judge.

¹³ See the original petition of proponents, at <http://www.ams.usda.gov/dairy/proposals/AGRIMARK.pdf>.

data that is now six years old. Rising costs, including exceptionally high energy costs, have imposed a hardship on the makers of the benchmark products. They cannot cover the increased costs that they are experiencing because under the methodology applied in the federal order system, if the average monthly market price of any of the four benchmark Class III or Class IV products rises for a month, the minimum milk price that they must pay to producers rises exactly in proportion. (Exhibit 16). This hearing was called to provide relief specifically to those manufacturers. 74 Fed. Reg. 545 (January 5, 2006).

Class I and II handlers, by contrast, can raise the price of their products without affecting the calculation of price they must pay producers for the milk used. The makers of ice cream, or bottlers of milk, can adjust their prices to cover their true costs over time. Their only constraint in doing so is the competitive market. Unlike the makers of the four benchmark products, their manufacturing margins are determined by a free market, without limitation by Federal order make allowances. (Exhibit 58, page 5).

Thus, the principal argument justifying make allowance changes in this proceeding only applies to Class III and Class IV products, and not to Class I or Class II products. Under these circumstances, maintaining the status quo with respect to Class I and II pricing, and only applying the proposed changes to Class III and Class IV pricing, is an “appropriate modification” [74 Fed. Reg. 545 (Jan. 5, 2006)] that follows logically from the initial proposal.

B. 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. They have argued 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 (Exhibit 16).

The only relationships between Class I/II prices and Class III/IV prices are those formal relationships that were defined during the Order Reform process. For example, the differential between Class II and Class IV prices is supposed to represent "the cost of drying condensed milk and re-wetting the solids to be used in Class II products." 64 Fed. Reg. 16104 (Apr. 2, 1999) Part of this cost is captured by the Class IV make allowance for nonfat dry milk. If this cost rises, the Class IV price goes down, but the difference between Class IV and Class II prices will increase by the same

¹⁴ For example, the March 2006 Class I and II advanced prices will be announced on February 17, using prices paid during January 28 through February 10; the Class III and IV prices for March 2006 will be 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.

amount.¹⁵ This purpose can be achieved by simply continuing to calculate the Class II prices using the present make allowances – *i.e.*, the status quo calculation of Class II prices will better maintain the intended relationship between Class II and Class IV prices.

The lack of an inherent price relationship with Class III/IV prices is even truer in the case of Class I milk. 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 the Class III formula or the Class IV formula. (Exhibit 16.) 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.* (April 2, 1999)). This same objective can be achieved by applying the new make allowances to Class III and IV milk pricing only: 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.

In addition, the application of increased make allowances to Class I and Class II milk would have the effect of diminishing the value of Class I differentials at a time when the costs of balancing Class I markets have risen for the cooperatives and marketing agencies that supply bottling plants. The final decision in the Order Reform proceeding recognized that Class I differentials must capture many costs associated with supplying fluid milk markets. (64 Fed. Reg. 16108, *et seq.* (April 2, 1999)). Specifically, these

¹⁵ If the hearing concludes that drying costs have risen by 30¢ per hundred pounds of milk, the effective differential between Class IV and II skim milk should also rise by 30¢. This point was made by Dr. Cryan in his testimony. (See Hearing transcript, Day 4, page 121-122.)

include maintaining quality and balancing fluid supplies across the various Federal Order regions. (64 Fed. Reg. 16109 (April 2, 1999)). The major portion of this burden is borne by either by dairy producers or by producer cooperatives who operate Class III and IV balancing plants; they are not borne by Class I handlers.

Producers and their cooperatives, who must ship milk longer than ever before to balance the supply of fluid milk across the various Federal Orders, also face rising fuel costs incurred in the refrigeration and transportation of fluid milk. In addition, producers and their cooperatives who primarily supply Class I handlers face higher costs of maintaining butter and powder plants that operate at less than full capacity in order to handle residual supplies that vary seasonally and from year to year. If Class I handlers incur any additional costs, they can capture such increases through higher market prices for their finished products. However, the producers and cooperatives who supply these processors, and who pay for the transportation of raw milk and such balancing costs as the manufacture of Class III and IV products, bear costs that rise in step with the manufacturing costs. (Exhibit 58, page 3-5).

As a result, it makes no sense to apply increased make allowances to the calculation of Class I milk because that takes revenue away from the dairy farmers and the cooperatives who are actually the ones incurring any increased costs associated with supplying the Class I market. The Federal milk marketing order scheme mandates a Class I differential to compensate dairy farmers for their contribution to balancing the market; applying increased make allowances would effectively discount the value of the Class I differentials to dairy producers, and compensate Class I handlers for costs that they are not incurring.

Conclusion

Ideally, any increase in the make allowances should be applied only to calculation of the price that dairy farmers receive for milk used to produce the four benchmark products (butter, nonfat dry milk, cheese, and dry whey), but this is impracticable. What is practicable is to limit the make allowance increases to the calculation of Class III and IV milk prices. For this reason, NMPF supports Agri-Mark's proposal to change the current make allowances to reflect more recent data, and to apply those updated make allowances in the calculation of Class III and Class IV prices. NMPF recommends, however, a modification of Agri-Mark's proposal to use a cost index to calculate monthly adjustments in energy costs.

However, reductions in the Class I and II prices are neither a necessary nor a desirable consequence of make allowance changes intended to provide relief for manufacturers of benchmark products. For that reason, NMPF also recommends that Agri-Mark's proposal be modified so that the new make allowances be used only in the calculation of Class III and Class IV prices. NMPF recommends that Class I and Class II prices continue to be calculated using the current make allowances.

The Administrative Law Judge's decision to exclude portions of NMPF's testimony regarding its recommended modification of the Agri-Mark proposal was in error. Moreover, the ruling jeopardizes the interests of America's dairy farmers who will lose hundreds of millions of dollars in revenue without justification if necessary modifications to the proposal are not made. NMPF respectfully requests that the Administrative Law Judge's decision to exclude be reconsidered and vacated; that NMPF's proffered testimony in Exhibit 58 be received in its entirety; and, if necessary, that the hearing be

reopened without delay and extended to take evidence and to engage full discussion on this issue crucial to the interests of dairy farmers across this country.

Respectfully submitted,

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