



International Dairy Foods Association
Milk Industry Foundation
National Cheese Institute
International Ice Cream Association

November 10, 2005

Ms. Dana Coale, Deputy Administrator
USDA - AMS - Dairy Programs
1400 Independence Avenue, SW
Washington, D.C. 20250-0225

Re: Petition of the National Cheese Institute (NCI) For an Expedited Hearing To Amend Federal Milk Marketing Orders

Dear Deputy Administrator Coale,

The National Cheese Institute (NCI) hereby petitions the Secretary of Agriculture to institute a proceeding to amend all current Federal Milk Market Orders (FMMOs), 7 C.F.R. Parts 1000 – 1135, on an expedited basis, to relieve the economic hardships on cheese manufacturers due to dramatically higher costs of manufacturing cheese since USDA last established manufacturing cost factors (make allowances) based on industry cost data from 1998 – 1999.

1. Introduction and Summary

The current make allowances were established by USDA based on evidence presented at a FMMO hearing held in May 2000. The evidence presented was based on industry cost data from the period 1998 – 1999, the most recent available at that time. Actual cheese plant manufacturing and related costs have risen significantly in the six years since. However, FMMO regulations strictly prevent cheese manufacturers from in any way recovering any portion of those higher costs through higher sales prices or other means.

When USDA implemented the 1996 Farm Bill's directive to reform FMMOs, it fundamentally altered the formulas for establishing the minimum prices which regulated dairy processing plants must pay dairy producers and milk marketing cooperatives for milk used in all dairy products. In doing so, USDA established a fixed relationship between the wholesale price of dairy products used in those formulas and the minimum class prices, with that fixed relationship based on the cost of producing cheese and other manufactured products ("the "make allowances"). However, USDA provided no mechanism to adjust that fixed relationship short of conducting a formal rule-making process.

Neither Congress nor USDA intended to threaten the economic viability of the U.S. cheese industry by forcing manufacturers to lose money on every pound of cheese produced, or potentially injure dairy producers by eliminating this important outlet for farm milk. However, the current system of FMMO regulated price formulas, unlike its predecessor, fixes the difference between the value cheese manufacturers obtain in the marketplace for their products and the minimum price they must pay for the milk used to make those products based on the industry costs as they existed at or before the May 2000 hearing at which the make allowances were established. Without any mechanism to adjust the make allowances in response to changes in industry costs, manufacturers are trapped into either losing money on every pound of product produced or stopping production entirely.

The method employed following the May 2000 hearing to establish make allowances used a weighted (by volume of dairy product production) average of two sources of industry cost data. The first is the annual published summary of the industry cost audit conducted by the California Department of Food and Agriculture (CDFA). The second was based on the results of a survey of dairy cooperative manufacturing plant costs conducted by the Rural Business Cooperative Service of USDA.

The cheese manufacturing industry urgently needs immediate relief from the highly injurious fixed relationship between output prices and minimum regulated milk prices that do not reflect current industry costs. Specifically, NCI seeks immediate consideration of the following proposed change in FMMO regulations:

Update the make allowances used in all FMMO minimum class price formulas using the same methodology used to establish the current make allowances, but with the most recently available industry cost data from both the California Department of Food and Agriculture and USDA's Rural Business Cooperative Service.

NCI requests that USDA promptly issue an expedited Notice of Hearing on the requested changes in the FMMO class price formulas. The Notice of Hearing should include the request that USDA omit a recommended decision so that a prompt final decision may be implemented immediately.

2. Explanation of the Problem

Prior to January 1, 2000, the minimum class prices for milk regulated by FMMOs were established based on the actual competitive market prices paid for unregulated (Grade B) milk in the upper Midwest. The Basic Formula Price (BFP) under FMMOs was based on the Minnesota – Wisconsin price series, a survey of the prices paid for Grade B milk in the second preceding month, updated by the changes in the weighted average of the wholesale prices for cheese, butter and nonfat dry milk between the second prior month and the immediately preceding month. While the minimum class prices moved up or down with changes in wholesale dairy product prices, the underlying market conditions for unregulated milk in the upper Midwest were the driving force in the level

of FMMO minimum class prices. Those competitive pay prices could, and did often, change in response to changes in industry manufacturing costs.

When the 1996 Farm Bill-directed reforms of FMMOs were first implemented in January 2000, the basis for determining class prices was shifted to an end-product pricing system. Rather than surveying competitive farm milk prices, USDA began to use surveys of actual market transaction prices for cheese, dry whey, butter and nonfat dry milk across the entire United States. USDA then uses those dairy product prices in conjunction with product yield factors and manufacturing cost allowances ("make allowances") in formulas which establish the value of the milk components; protein, other solids and butterfat or nonfat solids and butterfat. These component values, in turn, determine the minimum class prices to be paid by regulated processors for all farm milk.

The make allowances currently used throughout the FMMO system for cheese, dry whey, butter and nonfat dry milk were established following a hearing in May 2000. At that time, industry cost data were available for the years 1998 – 1999, and this formed the basis of testimony by a number of industry participants. In a decision based on that hearing, USDA fixed the make allowances for cheese, butter and nonfat dry milk by using data from two sources presented at the hearing. The first source was based on actual plant cost audits conducted by the California Department of Food and Agriculture (CDFA). The second source was a summary of a survey of dairy cooperative manufacturing plant costs conducted by the USDA's Rural Business Cooperative Service (RBCS). In both cases, the data came from actual industry costs during the period 1998 – 1999. The method adopted by USDA was to weight these two data sources by the volume of cheese, butter and nonfat dry milk represented by each data source.

At that time, neither of these two data sources included industry cost data for dry whey, and USDA relied on testimony at the hearing regarding the relationship in industry costs between nonfat dry milk and dry whey manufacturing to establish the dry whey make allowance.

USDA's National Agricultural Statistics Service (NASS) conducts weekly surveys of dairy product transaction prices (cheddar cheese, dry whey, butter and nonfat dry milk) from manufacturing plants across the entire United States. These weekly averages are used to calculate monthly, weighted average prices for these four products. The Department then uses those monthly average prices to determine the minimum component and class prices. In this manner, the FMMO minimum price of farm milk changes in conformity with changes in the wholesale prices of the manufactured dairy products in the market.

The fixed make allowances currently in place in all FMMOs are completely unresponsive to any changes in the actual costs incurred by manufacturing plants. Under the FMMO system, the FMMO minimum price for farm milk is the wholesale prices of the manufactured dairy products in the market as surveyed by NASS minus

the make allowance set forth in the FMMOs. Dairy product manufacturers under FMMOs are trapped into a fixed make allowance with no opportunity to cover their higher costs. If manufacturers raise their product prices to cover higher costs, those higher prices automatically lead to higher minimum component and class prices.

Industry manufacturing costs have changed substantially since the 1998 – 1999 period used to establish the current make allowances. One example is the data provided by CDFA, one of the two sources of industry cost data used by USDA to establish the current make allowances. At the May 2000 hearing, data published by CDFA in February 2000 was used. The most recent data published by CDFA is from December 2004. These data are presented in the following table:

Table 1: Cost to manufacture one pound of product, dollars per pound.

	Butter	Nonfat dry milk	Cheese	Whey
February 2000	\$0.0930	\$0.1277	\$0.1759	(1)
December 2004	\$0.1321	\$0.1551	\$0.1734	\$0.2675 (2)
Difference	+\$0.0361	+\$0.0277	-\$0.0025	

(1) CDFA did not collect whey costs prior to the December 2004 release.

(2) Survey period January 2002 through October 2003.

Source: CDFA

Due to the time necessary to conduct audits under the CDFA system, manufacturing cost data is already 6 to 12 months old at the time of publication. Therefore, even the data published in December 2004 represents the data period January 2003 through December 2003, with updates to some cost categories based on changes in price indexes through September 2004. CDFA expects to publish new data by early December 2005, which will reflect at least some of the recent period in which energy prices have been higher.

Even the data in Table 1 fails to fully describe the situation facing NCI members and other dairy product manufacturing plants regulated by FMMOs. The dairy products manufactured at FMMO plants compete directly with products manufactured at plants located in California and regulated by that state's regulations. For all manufactured dairy product make allowances used in FMMO and CA regulated minimum farm milk prices, the CA make allowances are higher, as seen in Table 2.

Table 2: Make allowances under both FMMO and California regulations.

Product	California	FMMO	Difference
NFDM	\$0.1560	\$0.1400	\$0.0160
Butter	\$0.1299	\$0.1150	\$0.0149
Cheese	\$0.1706	\$0.1650	\$0.0056
Dry Whey	\$0.2000	\$0.1590	\$0.0410

Source: AMS and CDFA

The second source of industry manufacturing cost data used by USDA as a result of the

May 2000 hearing was a survey conducted by USDA's Rural Business Cooperative Service (RBCS), the results of which were presented during that hearing by Dr. Charles Ling. Dr. Ling is in the process of conducting a new survey of cooperative dairy manufacturing plants and has expressed a willingness to again testify at a FMMO hearing regarding the results of this new survey. These results are expected to be available by mid-December 2005. Unlike data available from both CDFA and RBCS in May 2000, both sources plan to have data on dry whey costs.

In addition to the tables above containing CDFA data and make allowances, other secondary data clearly demonstrates the higher costs facing dairy product manufacturers. A recent study by researchers at the University of Wisconsin-Madison also looks at the impact of higher energy costs on dairy product manufacturers (Federal Order Product Price Formulas and Cheesemaker Margins: A Closer Look, by Ed Jesse and Brian W. Gould, Marketing and Policy Briefing Paper No. 90, October 2005). They conclude that changes in energy costs between January 2004 and September 2005 have increased the cost to take a hundredweight of milk and manufacture cheese, whey butter, and dry whey by 13.26 cents. The authors conclude that "In particular, competition would dictate that cheesemakers' gross margins rise and fall in response to changing costs. Formulas hold margins to a fixed amount that can only be changed through a laborious hearing process." They also state that "fixed margins can be a serious problem if they consistently yield sub-par returns and cause disinvestment in cheesemaking. Farmers and cheesemakers are partners – both must be profitable over the long run to sustain a healthy dairy industry."

In 2002, the last year without significant depooling, 55.7 billion pounds of FMMO milk was utilized to make cheese. Using the Jesse and Gould estimate of 13.26 cents per hundredweight, this calculates to an additional \$74 million cost incurred by cheese plants in the Federal Order system for energy cost increases since January 2004 alone. Other costs have also increased, as evidenced by data published by the U.S. Department of Labor's Bureau of Labor Statistics. Between the fourth quarter of 1999 and the third quarter of 2005, the employment cost index for wages and salaries in the manufacturing-non-durable-goods sector increased by nearly 18 percent (from 141.1 to 166.2). The increase in the employment cost index for benefits in the manufacturing sector was an even greater 42 percent (from 148.4 to 210.8). The increase in the industrial natural gas index was 165 percent (from 106.0 in December 1999 to 280.8 in September 2005); industrial electrical power increased 21 percent (from 129.5 in December 1999 to 156.6 in September 2005); and refined petroleum products increased 157 percent (from 75.6 in December 1999 to 194.6 in September 2005).

NCI member companies and other dairy product manufacturers can no longer cover their costs under current FMMO provisions. We are aware that Dairy Programs of USDA's Agricultural Marketing Service has already begun looking at this problem by asking Cornell University researchers to create a methodology to measure manufacturing costs while also conducting a survey of those costs. However, interim action is urgently needed to provide more rapid relief for the dairy manufacturing industry. The work being conducted by Cornell University researchers is unlikely to be

completed for all products used in the FMMO price formulas in time to address this enormous industry problem. The dairy manufacturing industry cannot wait for that data to become available, be debated by the industry, and initiate a lengthy hearing and decision process which considers all aspects of the Class III and IV FMMO price formulas. The last time USDA initiated such an undertaking with a hearing in May 2000, the final decision was not implemented until 35 months later in April 2003.

3. USDA can hold a hearing on short notice and render a final decision promptly without first publishing a recommended decision

USDA has been granted explicit legal authority to call hearings to consider FMMO amendments on as little as three days notice. 7 U.S.C. § 608c(17); see *also* 7 C.F.R. § 900.4(a). Furthermore, USDA is authorized to omit a recommended decision when necessary. The Administrative Procedure Act authorizes omission of a recommended decision "in a case in which the agency finds on the record that due and timely execution of its functions imperatively and unavoidably so requires." 5 U.S.C. § 557(b)(2). The Department's rules are to the same effect. 7 C.F.R. § 900.12(d).

Taking action here in an expeditious manner would be fully consistent with USDA's prior practice:

1) On September 30, 2004, USDA published in the Federal Register notice of a hearing to be held seven days later, on October 7, 2004, to consider the adoption of temporary transportation credits as a result of disruptions caused by hurricanes in the Southeastern United States. 69 Fed. Reg. 58368. Finding that emergency action was needed, USDA issued a final decision without first issuing a recommended decision. See 69 Federal Register 67670, 67677 (2004). The final decision was published on November 19, 2004, less than two months after the hearing was noticed.

2) In 1966, USDA held three regional hearings, which collectively covered all federal milk orders, for the purpose of substantially changing the Class I differentials then in existence. Notice of these hearings was published on March 5, 1966, with hearings commencing on March 9 and 10. See 31 Federal Register 3465, 3466 (1966). Based upon his finding that emergency action was needed, the Secretary issued a final decision without first issuing a recommended decision. See 31 Federal Register 5365, 5371, 5378 (1966). The final decision was published on April 5, 1966, a mere thirty days after the hearing was noticed, and the new Class I differentials were made effective as of April 10, 1966. See 31 Federal Register 5360, 5368, 5375, 5609, 5612, 5616 (1966).

3) USDA in 1974 promulgated emergency amendments changing the formula for setting minimum milk prices for manufactured products. The emergency decision was published on March 29, 1974, see 39 Fed. Reg. 11,567 (1974), only 45 days after the notice of hearing had been published on February 14, 1974. See 39 Fed. Reg. 5642 (1974). The hearing itself was held six days after publication of the notice of hearing. *Id.*

4) In 1982, USDA held emergency hearings to establish transportation credits. The notice of hearing was published on March 10, 1982, and the hearing

commenced six days later, on March 16, 1982. See 47 Fed. Reg. 10,230 (1982). The Emergency Decision was published on April 23, 1982 -- a mere 44 days after the notice of hearing. See 47 Fed. Reg. 17,530 (1982).

5) On January 26, 1998, USDA published notice of a hearing to commence less than one month later, on February 17, 1998, to consider proposals to floor the Class I and II prices. (63 Fed. Reg. 3667).

USDA is under no obligation to solicit additional proposals from other interested parties before holding a hearing for the purpose of updating the current make allowances. Neither the Agricultural Marketing Agreement Act of 1937 nor applicable USDA regulations impose any such requirement. The regulations simply provide that a person may file with USDA a proposed federal order amendment, and that USDA will serve a notice of hearing if deemed appropriate. 7 C.F.R. § 900.3.

Moreover, USDA historically has not solicited such proposals where, as here, the proponents of a specific proposal have demonstrated the need for prompt action. For example, available documentation indicates that no additional proposals were solicited in connection with the hearings discussed above in paragraphs 1, 2, 4 and 5.

NCI member companies and other dairy product manufacturers regulated by FMMOs are trapped by a fixed make allowance in combination with a surveyed commodity price, leaving no opportunity to cover their higher costs. If manufacturers raise their product prices to cover higher costs, those higher prices automatically lead to higher minimum component and class prices. NCI's proposal is very straightforward and can be accommodated through a very short hearing. The proposed method for determining make allowances is identical to that supported by most dairy producer groups during the May 2000 hearing; NCI is not proposing to reconsider or change the methodology used to set minimum prices, or the FMMO formulas, or the data sources used in those formulas. NCI only proposes to update the formulas by using the most currently available make allowance data from the same sources previously utilized.

NCI urges that USDA hold a hearing as soon as the updated CDFA and RBCS data is available and move expeditiously to a decision.

Respectively Submitted,

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