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September 29, 2005

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

Re: Request for an emergency hearing on changes in the Class III and IV price formulas

Dear Deputy Administrator Coale,

The following three changes in the Federal Order provisions for Section 1001.50 are being proposed on an emergency basis on behalf of Agri-Mark Dairy Cooperative and its 1272 dairy farmer members who are all regulated under the Northeast Federal Milk Marketing Order.

PROPOSAL 1

Agri-Mark's primary proposal is to update the manufacturing allowances for cheese, whey powder, butter and nonfat dry milk powder. The current allowances were fixed based upon now antiquated cost data from 1998-2000, yet are still used to establish minimum prices for milk under all Federal Milk Orders. Actual manufacturing and other costs have risen dramatically during the past five to seven years but Federal Order provisions have effectively stopped manufacturers from covering those higher costs through higher general sales prices or other means.

In order to simplify and hopefully quicken the time and efforts needed to update manufacturing allowances, Agri-Mark is proposing that the amended allowances be based upon the same two surveys from California and the USDA Cooperative Service that USDA has already used twice to set those allowances.

The California state manufacturing cost survey is conducted annually and the latest one is expected to be available this fall. Dr. Charles Ling of the USDA Cooperative Service has agreed to update his survey using recent data from past participants. The following cooperatives have agreed to participate: Land O' Lakes, Foremost Farms, Michigan Milk Producers, Associated Milk Producers, Northwest Milk Producers and Agri-Mark. This information would be used to update the manufacturing allowances as follows in Section 1000.50 class prices:

Sub sections:

- (l) butterfat price, current butter manufacturing allowances of 11.5 cents per pound,
- (m) nonfat solids price, current nonfat dry milk manufacturing allowances of 14 cents per pound,
- (n)(2) and (n)(3)(i) protein price, current cheese manufacturing allowances of 16.5 cents per pound,
- (o) other solids price, current whey powder manufacturing allowances of 15.9 cents per pound, and
- (q)(3) advanced butterfat pricing factor, current butter manufacturing allowances of 11.5 cents per pound.

JUSTIFICATION FOR PROPOSAL 1

On January 1, 2000, the basis for determining class prices for milk regulated under Federal Milk Marketing Orders was changed dramatically. Prior to that date, most class prices were determined using the competitively set M-W and Basic Formula Prices (BFP) that were paid for milk by dairy product manufacturers in the Upper Midwest. Those prices moved up or down as cheese and other dairy product prices moved. Those prices also moved if manufacturing costs changed and plants had more or less net income available to pay farmers for their milk.

When the Federal Orders were amended under major reform provisions in January 2000, the basis for determining class prices was shifted to an end-product pricing system. Rather than surveying competitively set farm milk prices, under this revised system, USDA surveys competitively set nationwide cheese, whey powder, butter and nonfat dry milk commodity wholesale prices. USDA then inserts those dairy product prices into formulas which, in turn, are used with administratively set product yields and manufacturing cost allowances in Order to determine the class prices to be paid by handlers for farm milk.

For the Class III milk price for example, the system functions by obtaining the cheese and whey products prices, and then subtracting fixed manufacturing allowances in order to end up with the net farm milk value. Appropriate yield factors are also used to convert dairy product pounds to pounds of raw farm milk components (and eventually, hundredweights of farm milk).

When USDA seeks the appropriate current dairy product prices to use in its class price calculations, it conducts weekly surveys of hundreds of plants so a reasonable monthly average price can be determined. The Department then automatically uses those prices to determine the appropriate class and component prices. Rightfully so, USDA wants the

price of milk to be responsive to any changes in the prices of the corresponding dairy products. However, similar care is not taken with the manufacturing cost allowances used in the same formulas. The fixed manufacturing cost allowances, currently in place throughout the Federal Order system, are completely unresponsive to any changes in actual costs until a Federal Order hearing is held and a USDA decision is determined to amend the appropriate provisions of the Federal Order regulations.

The manufacturing cost allowances currently in place throughout the Federal Order system for cheese, butter and nonfat dry milk as of January 1, 2001 are based upon cost data from a USDA Cooperative Service survey of costs at cooperative manufacturing plants in 1998 and 1999 and from a California state survey of instate manufacturing costs in 2000. Earlier versions of these same two surveys were used to determine the original Federal Order allowances effective on January 1, 2000.

Manufacturing costs for all dairy products have changed greatly from the 1998 to 2000 period. Energy costs have increased dramatically in the five to seven year period while medical related labor costs and insurance costs have increased substantially also. It would be incorrect, and in fact unreasonable, to assume that somehow technology or other efficiency improvements at existing plants have somehow entirely offset these escalating costs.

Dairy product manufacturers under Federal Milk Orders are trapped into a fixed make allowance with no opportunity to cover their higher costs no matter what the price of their dairy products are. If manufacturers raise their product prices to cover higher costs, those higher prices automatically lead to higher milk prices, leaving no additional net income to apply to the higher costs.

Dairy America, a cooperative federation of dairy cooperatives that manufacture and jointly market nonfat dry milk (of which Agri-Mark is a member), recently put a surcharge on nonfat dry milk powder to cover higher energy and other costs. However, they did not report that surcharge as part of the weekly USDA-NASS survey price. When USDA learned that, they automatically incorporated the higher price into the NASS survey, the Class IV price then rose and manufacturers ended up receiving nothing toward their higher costs.

This is a major problem for dairy product manufacturers like Agri-Mark who operate plants receiving milk under Federal Orders. Agri-Mark operates two cheese plants in Vermont, one cheese plant in New York and a butter/powder market balancing plant in Massachusetts. Agri-Mark's manufacturing costs are up over five cents per pound from 1998 to 2004 at our largest cheese/whey facility in Middlebury, Vermont. Energy, labor (particularly medical benefits) and plant/lab supplies are all up substantially. Butter manufacturing costs are up about two cents per pound during that same period and nonfat dry milk manufacturing costs are up over three cents per pound. We also provide over a billion pounds of milk to the Class I market, which represents about 40% of our total member milk production. Our competitors, who manufacture dairy products in California and Federally unregulated areas, do not have this same problem.

California has an end-product pricing system similar to Federal Orders. However, that state conducts annual manufacturing cost surveys and adjusts their manufacturing allowances accordingly. Currently, California has higher allowances for all dairy products and much higher allowances to manufacture whey powder, nonfat dry milk and butter. California is the largest milk producing state in the nation and, according to USDA statistics, produced 22% of the cheese, 31% of the butter and 52% of the nonfat dry milk produced in the nation last year (please see Table 1).

In order to help understand the scope of the problem faced by Agri-Mark and other manufacturers (and balancers) of Federal Order milk, the following table shows the current Federal Order manufacturing allowances as well as those in California. While California is important as a major competitor for all dairy products and their lower milk prices gives them a competitive price advantage in most common sales areas, the important issues about their following make allowances is that they are based upon audited financial information representing actual recent costs at California plants.

<u>Product</u>	<u>Manufacturing Allowances (\$/pound)</u>		
	<u>Federal Order</u>	<u>California</u>	<u>Difference</u>
Cheese	\$.1650	\$.1706	+.0056
Butter	\$.1150	\$.1299	+.0149
NFDM	\$.1400	\$.1560	+.0160
Whey	\$.1590	\$.2000	+.0410

California make allowances are higher than those used by the Federal Order for all products. While the cheese allowance is only about half a cent per pound higher, the whey powder allowance is over four cents per pound higher. Since the Federal Order Class III price formulas assume almost six pounds of whey powder in each hundredweight of milk, that lower Federal allowance alone unduly enhances Federal Order Class III prices by \$.24 per cwt.

Attached Table 1 shows the average volume of products manufactured at California plants versus the remainder of the country. On average, California cheddar cheese plants manufacture about 2 ½ times as much cheese as those in the rest of the nation. California butter plants average twice the production volume and the state's nonfat dry milk plants average four times the production volume. Most California manufacturing plants also are not as old as those in most other areas of the country. Due to economies of size and newer facilities, one would expect California plants to have lower manufacturing costs than those in the Federal Order.

Cheese makers and other dairy product manufacturers that serve as nearby outlets for local producer milk and as balancers of billions of pounds of Federal Order pool milk can no longer cover their costs under current Order provisions. The Northeast has seen a number of manufacturing plants close and watched as the region's annual Class III milk volume have fallen from 703 million pounds in 2001 to 454 pounds in the past 12 months. That's a 35% decline in only four years. The decline in Northeast cheese production would have been even greater had Agri-Mark not stepped forward in 2001

and kept the McCadam cheese plant in New York open after its owners decided to close it. On the other hand, as already noted, California cheese and dairy product manufacturing costs are surveyed annually and their class formulas have been adjusted accordingly.

California cheese plants usually pay about \$.30 to \$.60 less for their milk despite their newer and larger cheese operations. In 2004 the California announced minimum milk price paid by cheese manufacturers was \$.52 per cwt. less than the similarly announced minimum price under Federal Milk Orders. The most recent prices for August 2005 show Federal Order Class III milk users paid \$13.60 for their milk while California cheese makers paid \$12.99 for theirs. Class IV Federal Order plants also incurred a substantial difference when their Class IV price was \$13.44 in August compared to \$13.06 in California. It should come as no surprise that California cheese production has risen 42% in the last five years compared to a decline in the Federal Orders.

Upwards adjustments in the manufacturing allowances will initially result in lower class prices for milk under the Orders and a reduction in the farm blend price. As a farmer cooperative, Agri-Mark is always very concerned about anything that lowers the milk price to dairy farmers. However, dairy farmers in the Northeast are already bearing a financial burden due to the results of the insufficient make allowances. Several large cheese plants have already closed in the Northeast and that has forced farmers and their cooperatives to move milk to more distant plants at a greater cost that is passed onto farmers. In addition, competitive premiums paid to farmers are also under pressure as the local demand for milk falls.

In the Northeast, more milk has had to move to lower valued Class IV (butter/nonfat dry milk) balancing plants, increasing the Class IV utilization of milk. Had the Northeast Order had the same Class III utilization percentage in the past 12 months (August 2004 to July 2005) as it did in calendar year 2001, farm blend prices would have been \$.15 per hundredweight higher than they were. This problem will get worse as more manufacturing plants buy less milk or close entirely. In addition, Class IV balancing plants also are losing large sums of money due to the below costs fixed make allowances for butter and nonfat dry milk that are also set based on 1998/2000 costs.

Agri-Mark members have literally invested tens of millions of dollars into local plants in the Northeast while other dairy product companies have closed their facilities and sought cheaper manufacturing milk elsewhere. When manufacturing allowances are kept at a level below the costs of producing dairy products, farmers who have taken on the responsibility of balancing the milk and providing local homes for local milk end up receiving a lower net price than their neighbors. That is unfair to say the least.

We are aware that the Dairy Division 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. We believe that conducting such a survey and updating manufacturing allowances

up or down on an annual basis is the correct long-term solution to this problem. However, this work is just beginning.

It will likely take at least a year or so before results for all dairy products are available and another year or two (or longer) for the industry to review the results, debate them during the hearing process and see them codified into the Federal Orders. As a long term approach intended to be in place for many years, the Cornell work would certainly generate much controversy within the industry. Once Cornell has completed its work and before the hearing stage is begun, all segments of the industry should have the time and opportunity to understand and comment on the method used. Following that, a lengthy and complex hearing process and hearing record would likely occur. However, the dairy manufacturing industry can not wait that extended period of time as it is already suffering losses each day as a result of the obsolete cost structure. These antiquated manufacturing allowances need to be updated immediately by the best available means.

PROPOSAL 2

Adjust the protein price to accommodate the reduced value of whey butter in the Class III price formula.

Amend Section 1000.50(n) by including the following additional paragraph:

(4) Subtract \$.017 from the price computed pursuant to paragraphs (n) (2) and (n) (3) of this section.

JUSTIFICATION FOR PROPOSAL 2

Under current Federal Order provisions, both the butterfat and protein prices use the Grade AA butter price as the value for all types of butter production resulting from the use of Class III and Class IV milk. While that may be an appropriate value for Class IV component value calculations, it is not so for Class III values.

The Class III yield calculation, for milk testing 3.5% butterfat and 2.99% true protein, assumes a 90% butterfat retention in cheese with the remaining fat being used to produce whey butter. However, the butterfat and protein formulas further dictate that the resulting 0.42 pounds of whey butter be priced as if it were sold as Grade AA butter.

It is illegal under USDA's own regulations for whey butter to be labeled as Grade AA butter and it therefore does not have that Grade AA value in the marketplace. Agri-Mark's whey butter selling prices average more than \$.12 per pound below that of Grade AA butter. That \$.12 difference multiplied by the 0.42 pounds of whey butter equals \$.0504 cent per hundredweight of milk. Using USDA's standard of 2.99 pounds of protein in that same hundredweight of milk, the value per pound of protein should be reduced by \$.017 (\$.0504 divided by 2.99).

PROPOSAL 3

Reduce the 3 cent addition to the NASS survey price for barrel cheddar cheese to 1.5 cents with the following amendment to section 1000.50:

(n) (1) (ii) ...reported by the department for the month plus 1.5 cents.

JUSTIFICATION FOR PROPOSAL 3

Under current Federal Order provisions, the average of the NASS survey prices for 40-lb. block and 500-pound barrel cheese, weighted by the volume surveyed of each, is used in determination of the protein price for milk. However, before the average cheese price is determined, three cents is added to the 500 pound barrel price. According to USDA's original decision, these three cents represented the historical difference in prices (prior to 2000) between block and barrel cheese prices and somehow was a proxy for production costs differences.

Since the 38% moisture factor was included along with protein pricing in January 1, 2000, the historical difference between the block and barrel prices, has averaged 1.8 cents per pound. The appropriate Order provisions relating to protein pricing were last amended on April 1, 2003. Since April 1, 2003, that block/barrel difference has averaged less than \$.015 per pound.

Agri-Mark believes the barrel price should be excluded from the protein price calculation since the make allowances are specifically for block cheese production. Clearly an artificial three cents surcharge primarily based on historical statistics no longer applies and has unduly enhanced the cheese price beyond what the market price for block cheese has been. However, if USDA believes it should maintain the use of the already established barrel price series, the surcharge should be reduced to \$.015 cents until such time that the Cornell survey has determined the true costs of block and barrel cheddar cheese production.

EMERGENCY DECISION STATUS

Manufacturing costs have increased substantially since the 1998-2000 period used to determine the current manufacturing allowances, yet those allowances provided for under Federal Orders have remained fixed. The problem has further escalated since 2004 when energy prices have skyrocketed. Both the production of whey powder (Class III) and nonfat dry milk powder (Class IV) involve removing moisture and therefore are particularly energy intensive. However, rising energy costs have also impacted all aspects of the production of dairy products, as have increases in other costs.

Current manufacturing allowances are well below the actual costs involved in manufacturing cheese, whey powder, butter and nonfat dry milk powder. Every day that goes by means losses on the part of manufacturers who provide outlets for billions of pounds of Federal Order milk production as well as balancing services to their respective

Orders. In the case of Agri-Mark, these losses are directly incurred by member-farmers, who end up receiving a lower net price than other farmers who have shown no such commitment to the marketplace.

Both the whey butter and barrel cheese addition issues are on-going problems that have both unduly enhanced the Class III price for the past several years and have put cheese manufacturers using Federal Order milk at a competitive disadvantage with manufacturers not so regulated.

We clearly need these three proposals considered on an emergency basis to address these serious economic problems!

Agri-Mark and its members/owners appreciate your consideration of these proposals.

Sincerely,



Robert D. Wellington
Sr. Vice President for Economics, Communications and Legislative Affairs
Agri-Mark Dairy Cooperative

cc: Mr. Erik Rasmussen, Market Administrator
Northeast Milk Marketing Area

**TABLE 1: CHEESE, BUTTER, NONFAT DRY MILK AND WHEY POWDER PRODUCTION
FOR CALIFORNIA AND THE UNITED STATES, 2004**

	<u>CHEEDAR CHEESE</u>		<u>ALL CHEESE*</u>		<u>BUTTER</u>		<u>NONFAT DRY MILK</u>		<u>WHEY POWDER**</u>	
	<u>Volume</u> (mil.lbs.)	<u>Plants</u> number								
CALIFORNIA	538	14	1,996	63	389	13	737	10	118	5
as % of U.S	19%	9%	22%	16%	31%	19%	52%	21%	12%	14%
as % Other		247%		156%		198%		408%		91%
Other***	2,225	143	6,881	338	861	57	669	37	831	32
U.S.	2,763	157	8,877	401	1,250	70	1,406	47	949	37

*except cottage cheese

** for human consumption only

*** all states outside of California