

**TESTIMONY OF THE NATIONAL CHEESE INSTITUTE  
JANUARY 2006 FEDERAL MILK ORDER HEARINGS  
DOCKET NO. AO-14-A74, et al.; DA-06-01**

This testimony is submitted on behalf of the National Cheese Institute ("NCI"), a trade association representing manufacturers, marketers, distributors, and suppliers of cheese. NCI's approximately 70 member companies manufacture and/or market more than 80% of the cheese consumed in the U.S.

As buyers and processors of milk, NCI members have a critical interest in this hearing. Most of the milk bought and handled by NCI members is regulated under the federal milk marketing orders ("FMMO") promulgated pursuant to the Agricultural Marketing Agreement Act of 1937 (the "AMAA").

I am Dr. Robert D. Yonkers, Chief Economist and Director of Policy Analysis at the International Dairy Foods Association ("IDFA"), the umbrella organization that encompasses NCI. I have held that position since June 1998. I hold a Ph.D. in Agricultural Economics from Texas A&M University (1989); a Masters degree in Dairy Science from Texas A&M (1981); and a Bachelor of Science degree in Dairy Production from Kansas State University (1979). I have been a member of the American Agricultural Economics Association since 1984.

Prior to taking my current position at IDFA, I was a tenured faculty member in the Department of Agricultural Economics and Rural Sociology at The Pennsylvania State University, where I was employed for nine years. At Penn

State, I conducted research on the impacts of changing marketing conditions, alternative public policies, and emerging technologies on the dairy industry. In addition, I had statewide responsibilities to develop and deliver extension materials and programs on topics related to dairy marketing and policy. I have written and spoken extensively on economic issues related to the dairy industry, and I have prepared and delivered expert witness testimony to state legislatures and to Congress.

These hearings were called to consider whether any changes should be made to the Class III and Class IV make allowances currently contained in all FMMOs. NCI fully supports Proposal One as proposed by Agri-Mark and contained in the Notice of Hearing. For the reasons I am about to explain:

**1. USDA should update the make allowances used in all FMMO minimum class price formulas using the 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. Since the most recent data from these two sources covers industry cost data from 2004, these costs should be updated for the dramatic increases in energy costs between 2004 and 2005 using indices from the U.S. Bureau of Labor Statistics (BLS) for industrial electricity and industrial natural gas.**

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

**3. The make allowance for dry whey should be set no lower than 22.2 cents per pound.**

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

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

**6. The Department should omit a recommended decision and issue and implement a final decision and rule on as expedited a basis as soon as is reasonably possible.**

**I. THE CRITICAL IMPORTANCE OF MAKE ALLOWANCES IN A PRICING SYSTEM BASED UPON PRODUCT PRICE FORMULAS.**

Before addressing the specific make allowances that should be adopted, it is instructive to review the critical role they play under the current federal milk pricing system.

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 often did, change in

response to changes in industry manufacturing costs. Thus, the milk order pricing system could adjust automatically to changes in manufacturing costs, without any need to amend the terms of the FMMOs themselves.

Since January 1, 2000, however, the federal milk order system has adopted a new approach, which utilizes the price of finished products to determine the minimum milk prices that must be paid to farmers, through a mechanism commonly referred to as a "product price formula." Oversimplifying slightly, a product price formula sets the minimum prices that farmers must be paid for their milk as the price handlers receive for their finished products (such as cheese or butter) minus the costs the handlers incur in turning farm milk into those finished products (commonly referred to as the "make allowance").

In general terms, a make allowance is the difference between the wholesale sales value of a manufactured dairy product and the cost to purchase the raw milk necessary for that product's production. This make allowance is used for many economic purposes, e.g., to pay for the use of the capital necessary to build and maintain the plant, to cover the non-milk costs relating to obtaining raw milk, to pay for marketing the processed dairy product, to pay wages to employees of the manufacturing plant, to pay utility companies for the water, electricity and natural gas used to manufacture the dairy product, to buy ingredients other than raw milk, and to cover a wide variety of other expenses such as plant maintenance,

equipment, and insurance.

A hypothetical, but realistic example may help explain the concept of make allowances in product price formulas. Assume the example where the wholesale price of cheese is \$1.40 per pound and the total costs of manufacturing and marketing that cheese is 17 cents per pound of cheese. A manufacturing plant facing these assumed economic factors would be able to pay up to \$1.23 (\$1.40 minus \$0.17) for the raw milk needed to manufacture each pound of cheese.

What if this hypothetical plant is regulated under a federal order? If the make allowance specified in the regulated minimum price is 17 cents, this example plant can pay all the costs associated with manufacturing and marketing cheese after paying the regulated minimum milk price to the milk producers supplying the raw milk.

If, on the other hand, the make allowance specified in the regulations were 15 cents, the plant would be required to pay a minimum price of \$1.25 (\$1.40 minus \$0.15) to milk producers supplying milk. In this scenario, the plant would still receive the wholesale cheese price of \$1.40, but after being required to pay the minimum milk price of \$1.25 would only have 15 cents left to cover the total costs of turning that milk into cheese. But with actual total costs of manufacturing and marketing cheese of 17 cents, the plant would be unable to pay for one or more factors of manufacturing and marketing. Obviously the plant could not continue to

operate like this for any extended period of time.

It is easy to see through this simple but accurate example the critical need for a make allowance that covers the total costs of turning raw milk into a finished dairy product. Without an adequate level of make allowance, a manufacturing plant could not continue to operate, as it would have insufficient funds available to pay the vital costs necessary for operating the plant.

The extreme case would be if a manufacturing plant were required to pay the entire sales value of a dairy product to the supplier of the raw milk used for that product. In this extreme case, there would be no funds left to cover any of the costs associated with manufacturing and marketing the dairy product. The plant would be forced to cease operation, and a viable market for raw milk would no longer exist. But even if the manufacturing plant were permitted to hang on to some of the sales value, it will not be able to cover its costs fully unless it is entitled to hang onto enough money to pay for all of its costs.

Furthermore, if the manufacturing plant is not, in our example, getting enough money to cover its costs, it cannot simply raise its prices for its finished products, or lower the amount it is paying for its milk. In an *unregulated* market, that might be possible. The manufacturer would do one of two things—it would either raise the wholesale price of its products, or find a less costly source of raw milk.

But of course, we know that under the federal order system the handler cannot reduce what it is paying its farmers below the minimum regulated price. This option is a non-starter.

What is equally important to recognize is that the handler cannot escape from its conundrum by raising its finished product prices, either. We can see why this is so by returning to our example. Recall that the handler is selling cheese for \$1.40, the make allowance is 15 cents, and the minimum price of milk is therefore \$1.25. The handler is losing 2 cents for every pound of cheese it makes because its true costs of manufacturing is 17 cents, but it only has 15 cents left over after it pays for its milk.

So why can't the handler simply raise its price to \$1.42? The problem lies in the federal order minimum price formula. As previously noted, the minimum price is the price of the finished product minus the make allowance. In our example, before any finished product price increase, the minimum milk price was  $\$1.40 - 0.15 = \$1.25$ . After the finished product price increase, the minimum milk price is  $\$1.42 - 0.15 = \$1.27$ . Thus, all of the money derived from the increase in the finished product price has gone directly to the farmer, in the form of a higher, legally-mandated minimum milk price. None of the money derived from the finished product price increase has gone to the handler. After paying the now higher minimum milk price, the handler only has 15

cents left over—precisely the same amount as before it raised its finished product prices.

The same effect will result no matter how much (or, for that matter, how little) the handler attempts to raise its finished product prices. You can plug any price increase you want into the equation. The result is always the same, because the pricing formula works as a ratchet. All of the finished product price increase gets passed on to the farmer in the form of a higher minimum milk price. None of it is available to the handler to make up for the shortfall between the make allowance and the handler's true costs of manufacturing. Any steps it might take would be as futile as a dog chasing its own tail.

The example I have been using has focused upon cheese and its make allowance. But the same principles apply equally to all of the make allowances contained in the pricing formulas.

The only rational conclusion is simple and straightforward: too low a make allowance leads to reduced manufacturing capacity and reduced outlets for producer milk. FMMOs must be amended when their make allowances no longer reflect the real costs of making manufactured dairy products.

As was similarly observed by Ed Jesse and Brian W. Gould in their recent paper “Federal Order Product Price Formulas and Cheesemaker Margins: A Closer Look,” Marketing and Policy Briefing Paper No. 90, October 2005:



“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.”

USDA itself recognized this principle in adopting the current make allowances:

"[T]he make allowances incorporated in the component price formulas under the Federal milk orders should cover the costs of most of the processing plants that receive milk pooled under the orders. In part, this approach is necessary because pooled handlers must be able to compete with processors whose milk receipts are not priced in regulated markets. The principal reason for this approach, however, is to assure that the market is cleared of reserve milk supplies." November 7, 2002, 67 Federal Register Page 67915.

NCI believes that there are flaws in the current pricing system going beyond the make allowances. But given that these hearings are limited to make allowances, I will confine my testimony today to the ways in which the current make allowances need to be amended.

## **II. THE CURRENT MAKE ALLOWANCES ARE OUTDATED AND CAUSING SUBSTANTIAL HARM TO THE DAIRY INDUSTRY**

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 1997-99 depending on the dairy product, 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) based on the period January 1997 through April 1999. 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), based on the period 1998 through 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, the CDFA weighted average cost for all cheese plants in the survey was used by USDA. For butter, CDFA reported costs for two groups, the high cost and low cost groups. Based on average volume processed and indications of plant capacity utilization, USDA concluded that only the high cost group was comparable to the butter cost data from RBCS, and therefore used the weighted average of the CDFA high cost butter group only. For nonfat powder, CDFA reported costs for high, medium, and low cost groups; again, USDA concluded that it was most appropriate to use the weighted average of only the medium and low cost groups based on comparing both average plant volumes and capacity utilizations to the RBCS data. Finally, neither of these two data sources included industry cost data for dry whey in 2000.

Actual manufacturing and related costs have risen significantly in the six years since. However, as discussed in Section I, FMMO regulations strictly prevent manufacturers from in any way recovering any portion of those higher costs through higher sales prices or any other means.

Neither Congress nor USDA intended to threaten the economic viability of the U.S. dairy industry by forcing manufacturers to lose money on every pound of cheese or other product produced, or potentially injure dairy producers by eliminating this important outlet for farm milk. However, the current system of FMMO regulated price formulas fixes the difference between the value 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.

There is, therefore, an overwhelming and imperative need for immediate relief from the highly injurious fixed relationship between output prices and minimum regulated milk prices that do not reflect current industry costs. NCI accordingly supports updating the make allowances used in all FMMO minimum class price formulas using the methodology used to establish the current make

allowances, but with the most recently available industry cost data from both the CDFA and RBCS as updated by energy indices from the BLS.

The most recent data provided by CDFA were first published in November 2005, and an update for nonfat powder only was issued earlier this month. These data are presented in Table 1. Note that unlike data available from CDFA in May 2000, CDFA now does provide data on dry whey costs.

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

	Butter	Nonfat dry milk	Cheese	Whey
February 2000	\$0.0957	\$0.1356	\$0.1693	(1)
November 2005	\$0.1368	\$0.1571	\$0.1769	\$0.2673(2)
Difference	+\$0.0411	+\$0.0215	+\$0.0076	

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

(2) Survey period covers November 2003 through December 2004

Source: CDFA

Due to the time necessary to conduct audits under the CDFA system, manufacturing cost data is already 11 to 23 months old at the time of publication. Therefore, even the data published in December 2005 represents the data period January 2004 through December 2004.

The second source of industry manufacturing cost data used by USDA as a result of the May 2000 hearing was the RBCS, the results of which were presented during that hearing by Dr. Charles Ling. Dr. Ling has conducted a new survey of cooperative dairy manufacturing plants and has already testified at this hearing regarding the results of this new survey. As with the CDFA data, the

RBCS data now includes data on dry whey costs.

Table 2: RBCS cost to manufacture one pound of product, dollars per pound (1).

	Butter	Nonfat dry milk	Cheese	Whey
May 2000	\$0.1157 (2)	\$0.1520	\$0.1585	(3)
January 2006	\$0.1699	\$0.1917	\$0.1799	\$0.1565
Difference	+\$0.0542	+\$0.0397	+\$0.0214	

(1) All costs include the addition of CDFA data for general and administrative costs and CDFA return on investment.

(2) RBCS butter costs adjusted by subtracting the RBCS packaging costs and adding the CDFA butter packaging costs.

(3) RBCS did not report whey costs prior to January 2006.

Source: RBCS

USDA established the current make allowances based on the average of the RBCS and CDFA (selected groups by product) data, weighted by the volume of production represented by each data source. However, NCI notes that unlike the data available for the May 2000 hearing, the most recent CDFA data for different cost groups more closely match the most recent RBCS data. For butter, USDA should use the weighted average of all the butter plants in the CDFA data, which includes both the high and low cost groups, rather than only the high cost group used to calculate the current make allowance. In addition, the RBCS butter costs should be adjusted due to the fact that most of the butter in the RBCS survey was processed into one-pound prints, while the CDFA data was adjusted for bulk butter only; this should be done by subtracting the RBCS butter packaging cost and adding the CDFA packaging cost to the RBCS data for butter only. For NFDM, USDA should use the average for the medium cost group only, rather than the

weighted average of the low and medium cost groups used to calculate the current make allowance.

For cheese, USDA should use the weighted average of all the cost groups in the CDFA data, just as USDA concluded following the May 2000 hearing; in addition, since the CDFA data is all adjusted to a 40-lb block basis, USDA should use only the RBCS data on cheese plants with 40-lb blocks, rather than the average for all cheese plants as used by USDA to calculate the current make allowances.

The RBCS data is for in-plant costs only, and USDA concluded from the May 2000 hearing that an adjustment should be made to this data by adding the CDFA data for both general and administrative costs and return on investment. USDA should make the same adjustments in updating the make allowances. In addition, USDA also concluded following the May 2000 hearing to add a marketing cost of \$0.0015 to the weighted average of the RBCS and CDFA data, since neither cost data included marketing costs. Again, USDA should include this adjustment when updating the make allowances.

The CDFA and RBCS data now available represents industry costs from calendar year 2004. These reported costs ignore the significant increase in energy costs between 2004 and 2005. Therefore, USDA should include in the make allowances an adjustment for the increase in these energy costs. The Bureau

of Labor Statistics' price indices indicate that industrial electricity prices increased 6 percent and industrial natural gas prices increased 23.8 percent between 2004 and 2005. The RBCS data provides cost breakdowns for electricity and total fuels costs. USDA should apply these cost increases to the reported cost data for these two cost categories in updating the make allowances.

In May 2000, neither the CDFA nor RBCS reported data for the costs to manufacture dry whey. CDFA has reported skim whey powder data for the past two years. The weighted average costs exceeded \$0.267 cents per pound of skim whey powder produced in both years. After being first published last year, the California state milk regulation authorities decided to adopt a skim whey powder make allowance of only \$0.20, more than 6.7 cents per pound below the reported industry cost.

The RBCS is reporting whey cost data publicly for the first time at this hearing, and reported separate cost data for plants which only condense whey, from those which dry whey. The dry whey costs for the January 2006 RBCS data reported above in Table 2 indicate such costs are more than 3.5 cents per pound less than that for nonfat dry milk. This is inconsistent with testimony at both the May 2000 hearing and this hearing, which establish that the costs for dry whey exceed the costs for nonfat dry milk. In addition, the dry whey costs reported by CDFA are more than 11 cents per pound of product processed higher, or 70.8

percent higher.

Therefore, USDA should calculate the current dry whey make allowance by adjusting the nonfat dry milk make allowance for the incremental costs associated with drying whey. As testified by others at this hearing, USDA should add 2.5 cents per pound of product to the nonfat dry milk make allowance to determine the dry whey make allowance.

USDA should therefore amend the FMMO regulations to reflect the make allowances set forth in Table 3.

Table 3: Updated make allowances, dollars per pound.

	Butter	Nonfat dry milk	Cheese	Whey
January 2006	\$0.154	\$0.197	\$0.182	\$0.222

### **III. USDA SHOULD RENDER A FINAL DECISION PROMPTLY WITHOUT FIRST PUBLISHING A RECOMMENDED DECISION**

USDA is authorized to omit a recommended decision when the facts dictate a need for prompt action. The Administrative Procedure Act authorizes the 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).

The tremendous gap between the current make allowances and actual manufacturing costs cries out for prompt resolution. The Secretary is tasked under



the AMAA with maintaining orderly marketing conditions and with setting milk prices that reflect economic conditions that affect market supply and demand for milk and its products. These obligations cannot be fulfilled so long as the current outdated make allowances remain in place.

The due and timely execution of the Secretary's functions accordingly mandates that the Department issue a final decision without first issuing a recommended decision. Alternatively, the Department should issue and implement a tentative final decision and interim final rule, allowing for comments to be filed prior to the issuance of a final decision and final rule. This was the practice employed in the implementation of the current make allowances, as discussed at page 76850 of volume 65 of the Federal Register (Dec. 7, 2000).

