BEFORE THE SECRETARY OF AGRICULTURE AGRICULTURAL MARKETING SERVICE

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

Comments of the National Milk Producers Federation Regarding AMS Notice of Intent to Reconvene National Hearing

The National Milk Producers Federation (NMPF) hereby submits comments in response to the notice published by the Agricultural Marketing Service (AMS) of its intent to reconvene a national hearing in the above-captioned proceeding. 71 Fed. Reg. 36715 (June 28, 2006). NMPF is an association that represents the interests of more than 50,000 of America's estimated 65,000 dairy farmers.

The Proceedings to Date

The Agricultural Marketing Service (AMS) of the U.S. Department of Agriculture ("the Department") initiated these proceedings 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. See 71 Fed Reg. 545 (January 5, 2006).

Agri-Mark and others engaged in the manufacture of Class III and Class IV products have recently experienced significant increases in their costs, particularly in their costs of energy. (Exhibit 58). Because of the way that make allowances work in the Federal order system, they cannot pass on increased costs to the market because any market price increase automatically results in an equivalent increase in the price they pay for milk.

Agri-Mark sought to obtain relief for manufacturers of Class III and Class IV products, but its proposal contained the potentially unintended consequence of reducing the revenue dairy producers would receive for other sales. This is because under the current pricing methodologies Class I and Class II prices are determined using Class III and Class IV prices by reference. Because of the way the current pricing calculations work, Agri-Mark's proposal would not only decrease producer revenue from milk sold for Class III and Class IV use, but also from milk sold for Class I and Class II use.

USDA specifically noted this potential impact in its notice initiating these proceedings, stating 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).

At the hearing, USDA marketing order officials testified that if the proposed make allowance changes were applied to the calculation of the prices producers receive for Class I and II milk, the negative impact on producer income would be double that which would occur if the proposed changes were applied only in calculating the prices of Class III and Class IV milk. USDA program officials estimated the losses to producers from

reduced Class I and Class II revenues to be potentially as high as \$350 million. (Exhibit 2, Table A-4, summing all impacts on Class I and II revenue). ¹

NMPF proffered testimony that generally² supported Agri-Mark's proposal with respect to increasing the make allowance in the calculation of Class III and Class IV prices. ³ However, NMPF opposed, as unnecessary and unwarranted, ⁴ the application of the proposed make allowances changes in the calculation of Class I and Class II prices. NMPF suggested a modification to the Agri-Mark proposal – *i.e.*, that AMS accept the proposed make allowance changes for calculating Class III and Class IV prices, but that it maintain the current data and calculation methodology for determining Class I and Class II milk prices. (Exhibit 58).

Dr. Roger Cryan, NMPF's Director of Economic Analysis and designated witness in this proceeding, proffered testimony that the justification for Class III and Class IV

¹ USDA senior staff 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).

² NMPF recommended that the Agri-Mark proposal be slightly modified as it applies to Class III and Class IV milk, in particular that AMS use an index to calculate monthly adjustments in energy costs.

³ Although the Agri-Mark proposal would result in decreased revenues for producer pools, NMPF considered that it was a fair request in light of the cost increases that those manufacturers were incurring but could not recapture under existing rules. 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).

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 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.

make allowances arises from particular costs that are incurred by manufacturers of certain benchmark dairy products⁵; that the best and fairest way to compensate those manufacturers would be to establish make allowances for only those products, but that is impractical and so make allowances are 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 significantly adverse and unjustifiable economic consequences for dairy producers. 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

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⁵ 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. IV (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.

consideration.⁶ (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).

Despite the fact that Dr. Cryan's proffered testimony <u>directly</u> responded to the statement of purpose in AMS's prehearing notice – *i.e.*, <u>regarding the economic and marketing conditions which relate to Agri-Mark proposal and a recommended modification thereof – opponents of NMPF's position objected to its inclusion in the record. Inexplicably, the Administrative Law Judge ("ALJ") ruled in their favor and excluded NMPF's testimony on this crucial issue.</u>

⁶ In contrast to the situation for Class III and Class IV products (*see* fn. 6 above), 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.

NMPF's Recommendations with Respect to Further Actions and Proceedings.

1. The Secretary Should Overrule the ALJ's Decision to Exclude NMPF's Testimony.

The ALJ's decision to exclude NMPF's evidence was incorrect and the Secretary is under no obligation to adhere to that ruling. The rules of procedure applicable to these proceedings expressly provides that where a party has proffered evidence, the Secretary may subsequently "[decide] that the judge's ruling in excluding the evidence was erroneous" and, in such case, the proffered evidence "shall be considered a part of the transcript...." 7 C.F.R. 900.8(d)(6).

The ALJ erred in ruling to exclude NMPF's testimony because: (1) evidence of "any appropriate modification" was expressly solicited by AMS in the hearing notice⁷; (2) NMPF testimony was a "logical outgrowth" of the initial proposal and therefore permissible under well-established principles of administrative law; (3) the exclusion of evidence of a recommended alternative course of action is not the proper remedy in a rulemaking; and, (4) the ruling effectively 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. The Secretary should exercise his authority to supercede that mistaken evidentiary ruling and should act, pursuant to 7 C.F.R. 900.8(d)(6), to reinstate NMPF's proffered testimony in the record of this proceeding.

⁷ 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. IV [Jan. 27] at 49.

a. <u>NMPF's Evidence was Consistent with the Purpose of the Hearing</u> as Defined in the Federal Register Notice.

In its notice initiating these proceedings, AMS stated that

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, <u>and any appropriate modifications thereof</u>, to the tentative marketing agreements and to the orders.

71 Fed. Reg. 545 (emphasis added). NMPF responded <u>precisely</u> to AMS's statement of purpose by preparing and proffering testimony that (1) addressed the economic and marketing conditions that related to Agri-Mark's proposal to increase the make allowances for Class III and IV, and (2) suggested appropriate modifications to that proposal in light of the likely economic consequences.

The record reflects that the parties seeking to exclude NMPF's testimony disregarded, and the ALJ completely overlooked, the statement of purpose in the hearing notice.⁸ The ALJ's rationale for excluding NMPF's testimony-- that evidence of a modification to the initial proposal could not be received⁹ – directly contradicts AMS's

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.

⁸ In lengthy colloquies seeking to exclude Dr. Cryan's testimony, NMPF's opposition never even discussed this provision of the notice or explained how NMPF's suggested modification of the Agri-Mark proposal could be inappropriate in light of AMS's specific solicitation of evidence regarding modifications of the initial proposal. *See* Hearing Tr. IV (Jan.27, 2006) at 7-43.

⁹ When he ruled on motions to exclude NMPF testimony, the Administrative Law Judge stated inexplicably:

notice which called for just such evidence. The ALJ's ruling effectively read the phrase "any appropriate modification" out of the hearing notice in contravention of the most basic administrative law principles. 10

> b. NMPF Testimony Regarding Modification of the Agri-Mark Proposal was Proper Because it was a Logical Outgrowth of the Initial Proposal.

Even if the AMS pre-hearing notice had not expressly requested evidence with respect to appropriate modifications of the Agri-Mark proposal, NMPF's testimony would have been proper and fully admissible because it involved matters that were the logical outgrowth of the initial proposal. AMS was not limited, contrary to what ALJ was misled to believe, to accepting or rejecting the rule as originally proposed and published for comment. In Alto Dairy, a recent case that also involved a hearing to

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.

¹⁰ Moveover, the ALJ's assertion that the proffered evidence was beyond the scope of the hearing because the modification had not been considered by the Department of Agriculture in its "prehearing process" is inherently illogical. 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.

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). ^{II} 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, *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).

Evidence is the "logical outgrowth" of a proposed rule if 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, NMPF's proffered evidence qualifies because AMS specifically and appropriately requested evidence on "any appropriate modification" to the Agri-Mark proposal. ¹²

¹¹ 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). *See also Arizona Public Service Co. v. EPA,* 211 F.3d 1280 (D.C. Cir.), *cert. denied,* 532 U.S. 1970 (2000)

¹² 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 the "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 there would be recommended modifications of the 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. ¹³

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

¹³ 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. IV (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)

and Class IV products without any modifications, it would automatically change the pricing for Class I and Class II products.

c. The ALJ's Decision to Exclude NMPF's Testimony was Inconsistent with Other Evidentiary Rulings.

The ALJ's rulings with respect to other testimony offered on these same issues were inconsistent and confusing. For example, Dennis Schad, the representative of the Association of Dairy Cooperatives of the Northeast (ADCNE), also offered testimony opposing the application of the proposed make allowance changes to the pricing of Class I and Class II milk. When opposing counsel sought to strike this testimony as well, the ALJ permitted the testimony into the record making this curious ruling:

Rather than delay the hearing much longer, though, let's note the objection. It's going to be in the record anyway, and the Secretary can use it as a statement of position as opposed to evidence and a furthering of a proposal.

(Tr. IV at 274.)¹⁴

ADCNE's testimony fully supported NMPF's positions, including its opposition to the application of the proposed make allowance adjustment to the pricing of Class I and Class II milk. Mr. Schad testified:

While it is urgent to adjust the Class III and Class IV make allowances, and prices, it is not necessary, and would be positively detrimental to allow the changes to impact Class I and Class II prices. The Order 1 market illustrates well the issue: 35 percent of the utilization is in Classes III and IV and requires emergency price adjustments. However, 65 percent of utilization is in Classes I and II. These uses do not operate on pre-set make allowances; and the prices charged for the finished products are not reflected back in minimum class prices. The Class I and II competitive marketplace allows processors the opportunity to pass through to consumers increases in their costs of operation. There is no

¹⁴ The ALJ did not attempt to explain the legal consequences of this alleged distinction and, in fact, there is no legal rule or principle that limits the Secretary to consider testimony in the record as a "statement of position" as opposed to "evidence."

reason that producers should suffer price production [sic]¹⁵ on two pounds of production for every pound requiring the make allowance adjustment. The status quo should be preserved for Class I and II prices by simply retaining the current order language and formulae for advance Class I and II pricing factors. These prices are calculated independently of Class III and IV and should not be changed.

(Tr. IV at 257-58.) The ALJ subsequently admitted ADCNE's written testimony, which contained an identical statement, into evidence at Exhibit 64 in the proceeding.

Equally unclear and inconsistent was the ALJ's ruling with respect to the testimony of Mr. Elvin Hollon on behalf of DairyLea Cooperative and Dairy Farmers of America. Mr. Hollon testified:

We support the position that the change in make allowances which have been proposed and supported for reasonable cause are not warranted in the case of Class I and Class II pricing formulas. Margins for Class I and Class II products are not constrained in the same manner by the product price formulas as described here by Class III and Class IV manufacturers.

(Tr. IV at 271.) When other parties objected to this testimony, the ALJ permitted Mr. Hollon to testify and made the following ruling:

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. Proceed.

(Tr. IV at 275.)¹⁶

¹⁵ This is undoubtedly a typographical error in the transcript and should probably read "reduction" rather than "production."

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.

¹⁶ The confusion about what the ALJ had actually ruled is demonstrated by colloquy between the ALJ and the witness:

d. Exclusion of NMPF's Testimony was not a Proper Remedy in this Proceeding

Whatever the Secretary ultimately decides as a result of these proceedings, there is no basis for excluding highly relevant evidence with respect to the economic impact of the Agri-Mark proposal or 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.

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.

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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 – a penny one way or another makes a big difference to a lot of individual farmers.

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.

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) That case was entirely different on its facts and does not support, much less compel, the ruling to exclude evidence in this case.¹⁷

¹⁷ 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.

2. <u>The Secretary Should Proceed to Issue an Interim Final Rule Based on the Existing Record.</u>

a. An Emergency Exists for Manufacturers of Class III and Class IV Products that Warrants Immediate Action.

Fifty-eight percent of milk pooled in the Federal orders in 2004 was Class I and II milk. (Exhibit 58, page 5). 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.

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.¹⁸ The manufacturing

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.

¹⁸ See the original petition of proponents, at http://www.ams.usda.gov/dairy/proposals/AGRIMARK.pdf'.

margins built into the current formulas are fixed. Those fixed margins are based on cost 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).

b. NMPF's Proposed Modification Represents a Compromise that Recognizes the Interests of both Dairy Producers and Manufacturers of Class III and Class IV Products.

The Agricultural Marketing Act "was passed in 1937 to insure that American farmers receive a satisfactory price for their commodities...." *Walter Holm & Co. v. Hardin*, **449 F.2d 1009, 1012 (D.C.Cir. 1971).** To be consistent with the purpose underlying the Act, therefore, the primary focus of any administrative proceeding that contemplates changes to dairy marketing orders must be the potential impact on the prices that dairy farmers will receive for their products.

NMPF's suggested modification of the Agri-Mark proposal is the only recommendation in this proceeding that would ensure that this basic statutory goal was met and that would also provide reasonable accommodation to the competing interests in this proceeding. NMPF's proposal recognizes that producer cooperatives like Agri-Mark that are engaged in the manufacture of Class III and Class IV milk provide an important service to all dairy farmers by balancing the market -i.e., converting fluid milk to storable forms of dairy products such as cheese and butter during periods in the

production cycle when production outstrips demand for fluid product. Moreover, dairy product manufacturers provide an important market outlet for substantial quantities of the milk that dairy farmers produce. This directly benefits those dairy farmers those who are members of those manufacturing cooperatives, but has some indirect benefit for all dairy farmers.

The competing consideration for dairy farmers in this proceeding is the interest that all dairy farmers share in maximizing their Class I and Class II revenues. Unfortunately, Agri-Mark's initial proposal, which focused almost exclusively on the need for immediate relief for manufacturers of Class III and Class IV products in light of sky-rocketing energy costs, would inadvertently reduce producer revenues for Class I and Class II sales as well. But NMPF's recommended modification of the Agri-Mark proposal would address this problem by maintaining the current methodology for calculating Class I and Class II prices, and thus takes into account, and makes some accommodation for, both interests in the producer sector – those dairy farmers who are members of manufacturing cooperatives, and those who are not.

c. <u>The Record Contains Sufficient Evidence to Support a Decision on an Interim Basis.</u>

NMPF submits that there is substantial evidence in the record of an emergency situation that justifies the issuance of an interim final rule in this proceeding; and that there is substantial evidence to support the Secretary's adoption, on an interim basis, of the Agri-Mark proposal with the modifications that NMPF has recommended. NMPF urges the Secretary to act immediately by issuing an interim decision that adjusts make

allowances for Classes III and IV while withholding the application of these changes to Classes I and II pricing.

These proceedings were initiated as the result of a request by Agri-Mark, a farmerowned manufacturing cooperative, for emergency relief to address the crisis that Agri-Mark and others are facing because the system of manufacturing make allowances established more than six years ago has been rendered partially ineffective by recent economic changes. (71 FR 545). In the current proceeding, numerous witnesses testified that manufacturers of butter, nonfat dry milk, cheddar cheese, and dry whey who participate in the Federal order system, or whose milk purchases are effectively priced by the Federal order system, are currently constrained from recovering their costs of production by the make allowances in the Federal order pricing formulas. (Tr. I at 296-299; Tr. IV at 86-88; Tr. IV at 284-286; Ex. 58/60, 66; et al.) Under the current system, those manufacturers are "allowed" to recover a maximum fixed margin between their raw milk price and the price for the products they make. The formulae established for calculating the current make allowances for each of the four benchmark products were based on average costs of processing within the industry at the time of the original data collection (1998), but did not provide any mechanism for realizing cost increases. (67 FR 67920, 67921, 67926, 67930).

The hearing record in these proceedings makes clear that the costs that Class III and Class IV manufacturers are incurring – in particular, energy costs – have risen dramatically since 2000; that the current make allowances are now wholly inadequate to cover the costs of converting Class III and Class IV milk into the benchmark dairy products (see particularly, Exhibits 18 through 25; summarized and analyzed in Exhibit

58/60); and that there is an emergency that requires immediate relief. As the hearing witness for Leprino Foods stated:

Although there are several other aspects of the Class III/IV formula that we believe warrant review and correction, the urgent need for relief supercedes our interest in reviewing these other items at this time. We have anxiously awaited the completion of the cost study commissioned by AMS for the purposes of updating the Class III/IV formulas and had planned to seek a comprehensive hearing to consider the make allowance and other formula factors upon the data release. We continue to support the call of such a hearing in the future. However, given the delay in the completion of the AMS-commissioned study and the urgent need for relief, we believe that it is critical to move forward with an update of the make allowances in the milk price formulas on an emergency basis at this time.

(Tr. IV at 283-284). There was near unanimity among producer cooperatives (representing a large majority of U.S. milk production and U.S. milk producers) and processors (both cooperative and proprietary manufacturers representing altogether a majority of U.S. nonfat dry milk, butter, cheddar cheese, and dry whey production) that emergency relief was necessary and warranted. *See* Testimonies of Agri-Mark (Tr. I at 297 *et seq.*), Michigan Milk Producers (Tr. III at 109 *et seq.*), Associated Milk Producers, Inc. (Tr. III at 10 *et seq.*), Westfarm Foods (Tr. III at 339 *et seq.*), the National Cheese Institute (Tr. IV at 312 *et seq.*), Lacatalis (Tr. II at 309), Alto Dairy Cooperative (Tr. II at 328 *et seq.*), Association of Dairy Cooperatives in the Northeast (representing Agri-Mark, Dairylea Cooperative, Dairy Farmers of America, Land O' Lakes, Maryland and Virginia Milk Producers Cooperative Association, O-AT-KA Milk Products Cooperative, St. Albans Cooperative Creamery, and Upstate Farms Cooperative) (Tr. IV at 250 *et seq.*), Foremost Farms (Tr. III at 44 *et seq.*), Davisco Foods International (Tr. III at 103 *et seq.*), Saputo Cheese USA (Tr. III at 308 *et seq.*)

Family Dairies (Tr. III at 329 *et seq.*), Glanbia Foods (Tr. III at 389 *et seq.*), Hilmar Cheese (Tr. III at 396 *et seq.*), and Kraft Foods (Tr. III at 428 *et seq.*).

While the record substantially supports the position that the current system of make allowances is inadequate to compensate manufacturers of Class III and Class IV products for their costs, no similar record exists to demonstrate that the current make allowances are problematic with respect to the calculation of Class I and Class II prices. Indeed, there is no justification in the record for making changes to the current formulas for determining Class I and Class II prices.

Class III and IV prices are calculated based on the relationships between the dairy products and the milk used to produce them. The Class I skim milk price and Class II skim milk and butterfat prices are calculated using the Class III and IV price formulas by reference, and adding differentials that are designed to reflect their relationship to Class III and IV values. (7 CFR 1000.50) The Class II skim price has a specific relationship to the nonfat dry milk price: its 70¢ Class II differential is based upon the costs of drying and re-wetting milk, and so should rise and fall in lockstep with the make allowance for nonfat dry milk. (64 FR 16104) The minimum Class I differential of \$1.60 per hundredweight is based upon the cost of maintaining a Grade A (rather than Grade B) milk supply, fuel-dependent transportation costs and the costs of maintaining manufacturing capacity for balancing fluid milk supplies. (63 FR 4907-4910) That is, as Class III and IV manufacturing costs rise, so should the difference between the Class III and IV prices and the Class I and II prices. On the basis of the current record, it is clear that maintenance of the status quo for Class I and II is appropriate until these relationships can be clarified at hearing. There is no justification in the record for

applying the recommended revision of the make allowances for Class III and IV to the calculation of the Class I and II prices.¹⁹

In addition, there is substantial evidence of record demonstrating the negative economic impact on the producer sector that shows why the revisions proposed by Agri-Mark must be limited only to Class III and Class IV pricing. USDA's preliminary analysis of the Agri-Mark proposal delineates the economic impact that the proposal would have if the changes in make allowances were applied to all four classes. Table 3 in the hearing notice identifies changes in each of the four Class prices, and the impact on producer revenue associated with each of the four Classes. (71 FR 550-551) These individual impacts on Classes I and II are fair approximations of the impact of applying the proposed changes to all four Classes, instead of Classes III and IV only. In addition, NMPF's analysis (Ex. 58, pp. 3-5) provided additional analysis of the negative impact on producers of the original Agri-Mark proposal.

For these reasons NMPF proffered testimony in this proceeding recommending an appropriate modification of the Agri-Mark proposal. As discussed above, the ALJ's decision to exclude NMPF's testimony was erroneous and the Secretary should exercise his authority under 7 C.F.R. § 900.8(d)(6), to overrule that decision. In addition, the record contains substantial support for NMPF's suggested modification. The witness for Dairy Farmers of America, Inc., and Dairylea Cooperative, Inc., initially testified, over the objections of opposing parties, that they fully supported NMPF's recommended

¹⁹ The Class I butterfat price stands alone, based on the butter price. Since no evidence was presented to justify a change to this calculation, and since there is no emergency basis for changing it, it clearly should be left alone. (7 CFR 1000.50(c)&(q)(3))

modification.²⁰ NMPF's modification was also supported by the Association of Dairy Cooperatives in the Northeast (ADCNE) -- an association which represents Agri-Mark, Inc. (the original proponent), Dairylea Cooperative, Inc., Dairy Farmers of America, Inc., Land O' Lakes, Inc., Maryland and Virginia Milk Producers Cooperative Association, Inc., O-AT-KA Milk Products Cooperative, Inc., St. Albans Cooperative Creamery, Inc. and Upstate Farms Cooperative, Inc. (Tr. IV at 250-253) The ADCNE witness testified, despite objections of opposing parties, that their position was to support that of NMPF in holding Class I and II harmless from changes in the Class III and IV make allowances. (Tr. IV-257-258)²¹ Counsel for O-AT-KA Milk Products Cooperative also argued forcefully in favor of holding Class I and II harmless. (Tr. IV-58-61) Finally, the witness for Southeast Milk, Inc., attempted to testify in favor of holding Class I and II harmless, but his testimony in that regard was also erroneously excluded by the ALJ. (Exhibit 61, p. 2; Tr. IV-72).²²

NMPF supports the Agri-Mark proposal to the extent that the proposed changes to the make allowance formulas are applied only to Class III and Class IV pricing. This limited application of the proposal would make a clear incremental improvement in the calculation of milk price formulas. The data that were submitted into the record in support of the proposed changes are the same data -- identical in source and method -- as the data that were used in the 2000 proceeding to establish the current Class III and IV

²⁰ Their witness testified that they had compelled by the administrative law judge's ruling excluding NMPF's testimony to adopt a position in opposition to a change in the make allowances. (Tr. IV at 271-278)

²¹ He stated that, "While it is urgent to adjust the Class III and IV make allowances, and prices, it is not necessary, and would be positively detrimental to allow the changes to impact Class I and Class II prices. (Tr. IV at 257) For this statement, the witness was accused of "duplicity" by USDA counsel. (Tr. IV at 264)

For the same reasons cited above, the Secretary should exercise his authority under 7 C.F.R. §900.8(d)(6) to overrule the ALJ's decision to exclude Southeast Milk's testimony.

price formulas. (Exhibits 18 through 25; summarized and analyzed in Exhibit 58/60; compare with 67 FR 67920, 67921, 67926, 67930). The yield factors in the formulas reflect the yields of dairy product from dairy components. (64 FR 16098) Changes made based on the May 2000 hearing were corrections and adjustments based on re-evaluation of the facts, but assumed no change in the dairy chemistry. (67 FR 67911). ²³

d. The Secretary has the Authority to Proceed to Issue a Final Rule on an Interim Basis.

In *Walter Holm*, *supra*, the D.C. Court of Appeals construed section 608(c) of the Agriculture Marketing Act to provide authority to the Secretary to issue interim final rules in circumstances such as these. The Court stated:

There is no statutory provision for "temporary" orders under § 8c. But an order issued under § 8c after full hearing may reasonably provide for further implementation (a) in part by regulations issued only after opportunity for comment, and (b) as to novel or crucial matters, by regulations issued only after opportunity for effective oral presentation subject to provision, when needed, of temporary regulation, in the interim, on the basis of comments preceding oral presentation.

449 F.2d. at 1016. In numerous instances in the past, the Secretary has exercised his authority to issue interim final regulations in emergency situations subject to the condition that the Department would receive subsequent comments. In this case there is both substantial evidence of record supporting NMPF's suggested modification and the opportunity, in the context of the reopened hearing proceedings recently announced, for the Department to take comments and arguments from all interested parties. If those

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²³ As discussed on the record the basic dairy chemistry upon which these factors are based has not changed. (Tr. IV at 120). Yields of product per hundredweight of milk can change with raw milk component tests, and product yields per volume capacity of equipment can change as additional, concentrated dairy products are added. However, the yields of standard product per pound of components have not changed.

comment warrant any further changes, the Department will be able to make them when it issues its final determination.

3. NMPF Supports the Secretary's Decision to Hold Additional Hearings.

Even though the proposed revisions to the make allowances calculations are incremental, they will, nonetheless, operate to alleviate the immediate crisis faced by manufacturers of cheddar cheese and dry whey, and butter and nonfat dry milk. In its recent Notice of Intent to Reconvene National Hearing (71 FR 36715), the Department indicated that it intended to hold additional hearings to include in the record "data on plant manufacturing costs currently being compiled by Cornell University or any other pertinent data or information that would be publicly available" before making a final decision on the Class III and Class IV price formulas. While NMPF agrees that hearings should be held on a broader range of issues beyond Class III and IV make allowances.²⁴ and that additional data could help to produce a more precise final decision, the current emergency that Agri-Mark and others face require timely and reasonable action, not absolute perfection. The data available to the Secretary in the current record are more than adequate to serve as the basis for an immediate interim decision that will address the emergency with which manufacturers are now confronted.

Numerous participants at the hearing anticipated that a future proceeding would address Class price formulas in more detail, and the current proceeding would simply

NMPF believes that the invitation for additional proposals contained in this notice could and should open the proceeding to allow for consideration of other elements of the Class price formulas, including yield and shrinkage factors, balancing costs, and Class I and II differentials.

address the necessary short-run revision of the Class III and IV make allowances. (Agri-Mark at Tr. III-234-236; Hilmar at Tr. III-398; Kraft at Tr. III-430; NMPF at Tr. IV-100; Leprino at Tr. IV-284) The Department's intent to reconvene the hearing offers an excellent opportunity to address both short-run and long-run expectations in a timely manner: an interim decision applied only to the Class III and IV prices will effectively address the emergency upon which the original petition was predicated, while a reconvened hearing may properly address the broad set of issues which the industry and USDA anticipated considering in a future proceeding.

The "data on plant manufacturing costs currently being compiled by Cornell University" (referred to in AMS's Notice to Reopen, 71 FR 36715) may contribute substantially to the record of a final decision; but they are unnecessary to the issuance of an interim rule that would improve upon the current rule and relieve the distressed manufacturers of the four benchmark dairy products.

Both cooperative-owned and proprietary plants are facing substantial losses based on the constraints imposed upon them by the inadequate make allowances. All dairy producers depend upon an outlet for their milk; if these plants are unable to remain in business, their output will be lost and their demand for milk will disappear. The general health of the industry depends upon a functioning processing sector; regulation that denies the possibility of covering processing costs is becoming a bottleneck that could choke the entire industry, create price distortions, and jeopardize the viability of the Federal order system itself. For these reasons, we urge the Department to issue an interim decision that applies adjusted make allowances to Class III and IV prices and only to Class III and IV prices.

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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

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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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