

Before the Secretary
United States Department of Agriculture

Regarding Milk in the Northeast and Other Marketing Areas
Proposed Amendments to Orders

Docket Nos. AO-14-A74, et al. and DA-06-01

January 24, 2006

Hearing Brief

By Dennis J Schad, Director of Regulatory Affairs
Land O'Lakes, Inc
405 Park Drive
Carlisle, PA 17013

Land O'Lakes (LOL) is a dairy cooperative with more than 4,000 dairy farmer member-owners. The cooperative has a national membership base, whose members are pooled on six different Federal orders. Land O'Lakes owns three cheese plants and a butter/powder plant that are regulated by the Federal orders. Economic conditions at cooperative's manufacturing plants have caused LOL to request and to give testimony at the January 24 Hearing. Land O'Lakes' Carlisle PA and Kiel WI plants have incurred losses that are a result of the outdated manufacturing costs currently contained in the FMO class price formulas.

**The Current Make Allowances are Defective Due to Incorrect Evidence
Presented at the 2000 Hearing**

Charles Ling testified that two California butter and powder plants were included in the Rural Cooperative Business Service (RCBS) survey that was presented at the Class III/IV Hearing in 2000. Since the plants were also included in the California Department of Food and Agriculture (CDFA) survey, the resulting RCBS/CDFA weighted average costs were under-reported. Had the proponents testified to the actual cost of manufacturing butter and NFDM in the RCBS survey, the butter make allowance may have

been \$0.005 per pound higher and the NFDM make allowance could have been \$0.002 or \$0.005 greater than the current FMO make allowances for those commodities.

The significance in Dr Ling's testimony is that the current make allowances are flawed and that we must put the 2003 Class III/IV Final Decision in perspective as a point of comparison for changes resulting from this hearing.

USDA Should Accept Agri-Mark's Proposals for Make Allowance Revisions

The representatives from Agri-Mark testified to increase the cheese make allowance to \$0.1815 (a \$0.0165 increase); butter to \$0.1543 (a \$0.0393 increase); nonfat dry milk to \$0.1965 (a \$0.0565 increase) and whey \$0.2215 (a \$0.0625 increase) per pound (Exhibit 29). Proposal 1 was supported by the National Milk Producers' Federation and its 33-cooperative members, by the Association of Dairy Cooperatives of the Northeast and its eight-cooperative members and individually by Land O'Lakes, AMPI, O-AT-KA, Michigan Milk Producers Federation, Northwest Dairymen's Association and Foremost Dairies. Agri-Mark's proposal was also supported by the National Cheese Institute and its 70-cooperatively and privately- owned cheese manufacturers. Additionally, at least six cheese manufacturers supported Agri-Mark and testified to the higher costs in their operations since the 2000 hearing.

The methodology supporting Agri-Mark's proposal is the same methodology applied by USDA in the 2003 Final Rule for Class III and IV prices. USDA weighted the best available survey of production costs in manufacturing plants located in the Federal Order marketing areas, the RCBS Survey, with the CDFA Manufacturing Cost Survey. The Department then chose the appropriate CDFA commodity group or sub-group to average with the RCBS survey. The Department determined the appropriate CDFA commodity group or subgroup for the weighted average calculation based on three criteria: comparative plant throughput; average cost per pound and recognition of the balancing costs in the FMO marketing areas. Additionally, USDA noted that some costs, return on investment and general/administrative costs, were included in the CDFA survey but not the RCBS survey. The Department determined that these costs should be added to the RCBS survey and used the CDFA costs as a proxy. Moreover, USDA

concluded that a marketing cost of \$0.0015 per pound was appropriate and should be added to both surveys.

Balancing costs are implied in the RCBS cost survey. Plant costs in both the RCBS and CDFA surveys are reported as costs per pound. In the Tentative Decision (Federal Register/Vol.65, No. 236/December 7, 2000/Page 76841) the Secretary commented on the treatment of plant losses and shrinkage in the make allowance calculation. He noted that all manufacturing costs are included in the surveys and that costs are expressed as cost per pound of product produced. Since all plant manufacturing costs are divided by total plant output, the Secretary concluded that plant losses and shrinkage were implied in the make allowance formulas. Similarly, the RCBS survey includes all manufacturing costs including the costs associated with balancing the market.

Charles Ling stated in his testimony that “The nature of a plant might affect its manufacturing cost. A plant used strictly for manufacturing purposes tends to have a relatively constant milk volume and is operated at a high rate of capacity. It is likely to have a lower cost than a plant for balancing milk supply.” (Notes of Testimony/Dr. Charles Ling/January 24, 2006/Page 97) Witnesses representing Agri-Mark and Land O’Lakes testified to the role of Class IV balancing plants. From a macro level, Class IV volumes pooled on Order 1 ranged from a low of 2.1 billion pounds in 2000 to a high of 2.9 billion pounds in 2005. (Exhibit 29, Table 2) Commenting on the difference in Class IV volumes between 2003 and 2004 (700 million pounds) in Federal Order 1, Bob Wellington said, “These Class IV plants took in the extra milk to clear the markets of surplus milk, not because it was profitable to do so.” (Notes of Testimony/Robert Wellington/January 24, 2006/Page 303) Exhibit 42, Page K shows the monthly changes in total solids receipts at Land O’Lakes’ Carlisle butter/powder plant during 2001 and 2002. During a 9-month period plant receipts ranged from 50 percent to 100 percent of plant capacity.

Clearly, Class IV butter and nonfat dry milk plants in the RCBS survey experience higher costs than their California counterparts due to this huge fluctuation in plant utilization resulting from the balancing of Class I and II needs in Federal Order markets. For all commodities, the RCBS average plant throughput is less than the California average and the adjusted cost per pound to manufacture is higher in the RCBS plants than the California weighted average. The inference is that the plants in the RCBS survey

perform greater balancing functions than their California counterparts. While it is impossible to assign a specific cost of balancing in the make allowance formulas, Land O'Lakes recommends that the Secretary consider the role of balancing plants and their accompanying costs when assigning the appropriate California group or sub-group to average with the RCBS surveys.

Neither the RCBS nor CDFA whey surveys provide useful measurements regarding the cost of processing and drying whey. CDFA has only reported two whey surveys and the current RCBS survey is the first. For two years the CDFA reported the cost of producing whey more than \$0.26 per pound. However the California whey make allowance is only \$0.20 per pound. Intuitively one would expect the cost of drying whey to be at least equal to the cost of drying skim milk. The witness from Westfarm Foods made a persuasive argument that the drying cost of whey was 2 ½ to 2 ¾ cents greater than the cost of drying skim milk. The current whey make allowance was decided by adding a factor to the cost of drying NFDM. Land O'Lakes recommends that the Secretary determine the whey make allowance by adding a factor consistent with the testimony of the witness representing Westfarm Foods to the cost of drying NFDM.

Opponents to the Agri-Mark proposal included individual dairy farmers and cooperatives. Collectively they did not dispute the RCBS or CDFA surveys and offered no alternative proposals. The common thread in their testimony and opposition was the anticipated effect to class and ultimately producer prices that would result from an increase in make allowances. The arithmetic is undisputed; increase the make allowances and class prices and producer prices will decrease. However, it is important to put the price change in context and to point out the relative changes in producer prices. Exhibit 13 reports the changes in class and uniform prices for the several Federal orders. The effects for Federal Order 1 are reported on page 7. The worst-case decrease in producer prices occurs with the implementation of Scenario 3, a \$0.45 cent per hundredweight decrease. Compared to the two-year average uniform price in Federal Order 1, this decrease represents a 2.8 percent decrease for producers associated with the Northeast market. Similarly, Scenario 3 produces a 2.6 percent price decrease in the Florida market (Page 9) and a 2.9 percent decrease in uniform price in the Southwest order (Page 15).

The testimony contained in Exhibit 13 provides a static comparison where the underlying assumption is that no other factors, except make allowances, change. However, the analysis contained in the Hearing Call (Exhibit 1) provides a more robust analysis of the changes that would follow an updating of the Federal order make allowances. In that analysis USDA utilized an econometric model that accounts for the demand and supply responses that would follow changes in make allowances over a longer time span. USDA forecasts that dairy farmers should expect to experience an average 9-cent decrease in all-milk prices over a 5-year period from the adoption of Scenario 3. Additionally, it was pointed out that some portion of the 9-cent decrease is currently being absorbed by those dairy farmers who own plants and balance the markets. Therefore, a portion of those costs currently incurred by some dairy farmers will be shifted from that sub-group to the entire market following the adoption of changes in the make allowances (Notes of Testimony/Robert Wellington/January 25, 2006/ pages 229-32).

USDA Should Adopt the Energy Adjuster Proposed by the National Milk Producers' Federation

Land O'Lakes recommends that the Secretary issue a tentative decision, updating the current cost indices that set the FMO class prices. The Agri-Mark proposal includes provisions to update the 2004 RCBS and CDFA averages to 2005 energy costs. While all manufacturing costs have increased between the 1998 and 2004 RCBS surveys, energy costs have been among the most volatile. Between the surveys, the combined electricity/fuels cost per pound of product increased by 32 percent for the manufacture of 40-pound blocks of cheddar, by 59 percent for butter and 85 percent for NFDM (Exhibits 18 and 20). Moreover, the combined electricity/fuels cost per pound of product represented 7 percent of the average cost to manufacture 40-pound cheddar blocks, 10 percent of the average cost of butter and 23 percent of the average cost of NFDM (Exhibit 18). For the 2000 Class III/IV Hearing USDA used the most up to date cost indices to set the current make allowances for class prices. The Agri-Mark proposal allows the Department to set 2006 class prices on the most current manufacturing costs.

Land O'Lakes supports the NMPF proposal to include an energy index in the make allowance calculations. As noted earlier, energy costs have been volatile and energy is a major component in the average cost of production

for dairy plants. Due to the inclusion of all customer payments in the NASS price surveys, it is impossible for manufacturers to recoup increased energy prices from their customers. NMPF's energy adjuster proposal would allow the make allowances to move based on energy costs. While NMPF recommends a monthly adjustment, Land O'Lakes suggests that a quarterly adjustment may be less disruptive to forward pricing contracts. LOL also recognizes that an energy adjuster is a new concept for dairy pricing and it may take additional time for the Department to digest the Hearing testimony relative to the NMPF proposal. For that reason, Land O'Lakes recommends that the Secretary issue a recommended decision based on the Agri-Mark proposal and include the NMPF energy adjuster in a Final Decision.

USDA Should not Reopen the Hearing for Additional Testimony

While supportive of a new hearing to address the pricing of Class I and II products in light of the proposed changes to the make allowances, Land O'Lakes is opposed to reopening the current hearing record. We agree with the Administrative Law Judge's decision that the NMPF proposal was outside the scope of the Hearing Notice and not at issue at this hearing. Similarly, Land O'Lakes opposes the objection made by the legal representative of Select and Continental Milk Producers that the hearing should include testimony relating to product pricing surveys and product yields.

The Notice of Hearing was responsive to industry requests for a focused hearing on the changes in processing costs between the 2000 Hearing and the present. We commend the Secretary for recognizing the problems faced by manufacturing plants and expediting the regulatory process to address the narrow issue.

Testimony was presented that the current make allowances for butter and powder are understated and defective. Reopening the Hearing will delay updating the make allowances and correcting the defective make allowances derived from the 2000 Hearing Record.

Need for an Emergency Decision

Land O'Lakes commends the Secretary and his staff for recognizing the urgency of the issue for dairy manufacturing plants by scheduling a timely hearing.

Since 1998, dairy manufacturing costs have greatly increased. Fixed make allowances and NASS pricing regulations hinder manufacturers of Class III and IV products from finding relief from higher costs in the marketplace. All industry witnesses testified to profitability squeeze at their plants. The only relief possible for federally regulated plants is an adjustment to the make allowances.

Land O'Lakes requests that the Secretary revise the Class III and IV make allowances at the earliest possible date and implement those changes without a recommended decision.