

COMMONWEALTH OF PUERTO RICO
Department of Agriculture
OFFICE FOR THE REGULATION OF THE MILK INDUSTRY
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**REGULATIONS ACT NO. 12 OF THE MILK INDUSTRY FOR
FIXATION OF MILK PRICES AT ALL LEVELS**

SECTION 1. Short title:

This regulation act will be titled and may be cited as Regulation Act No. 12 of the Milk Industry.

SECTION 2. Basis and authority:

Law Act No. 34 of June 11, 1957, as amended (5 LPRC §1092, et seq.) bestows the Administrator whose signature appears in this document with the power for investigating and regulating all aspects of the milk industry and its derivative products, including production, elaboration, sterilization, manufacturing, storing, purchase and sales, transportation, and distribution of its principal product and its derivatives. (See item A of Article No. 5 OF Law Act No. 34, supra, 5 LPRC § 1096a).

Exercising said regulation powers, this administrative agency has approved and disseminated orders which determine prices for the milk produced by licensed farmers, manufacturers, and consumers. Constitutional law requires that, at least once a year, this office examine the costs of production, manufacturing, distribution, and sales of the milk produced by farmers, including the price of the surplus milk sent to processing plants for manufacturing other dairy products.

SECTION 3. Purpose:

In 2004, the milk manufacturers of the Island, Vaquería Tres Monjitas, Inc. and Suiza Dairy, Inc., filed a lawsuit against the Secretary of Agriculture and the Administrator of ORIL at the U.S. District Court for the District of Puerto Rico objecting to the price regulation established by this administrative agency, which is appointed by the Department of Agriculture of the Commonwealth of Puerto Rico. In the lawsuit, both milk manufacturers requested—among other things—preliminary and permanent court orders against said regulations. (*Vaquería Tres Monjitas, Inc. and Suiza Dairy, Inc. vs. José O. Fabre Laboy, et als., U.S. District Court For the District of Puerto Rico, Civil Case #04-1840*). On July 13, 2007, said Court issued an opinion and order to initially grant the preliminary court order requested by the manufacturers who filed the suit. Said opinion and order forces us to promote certain remedial regulations immediately.

It is also required that this regulation is based on “regulating standards” to determine costs and reasonable returns for all the participants in the milk market. These parameters must comply with the regulating principles included in this regulations act and which we hereby adopt in compliance with the judicial order mentioned above.

On July 31, 2007, this administrative agency held a public hearing with the intention of calling for proposals related to the status of the milk industry in Puerto Rico and regarding additional regulations that may be deemed necessary to determine prices with reasonable returns for each of the components.

Representatives of milk manufacturers and producers attended the hearing, where they voiced recommendations and submitted documents and data, both during the hearing and in the days that followed. The data supplied by the participants was analyzed by specialists in the matter hired by our agency to write this regulations act and enact it, in compliance with the aforementioned judicial order.

SECTION 4. Definitions:

1. Administrator- administers the Office for the Regulation of the Milk Industry.
2. Administrative Agency – refers to the Office for the Regulation of the Milk Industry.
3. Raw milk - is the lacteal secretion (milk), not including colostrums, obtained upon milking one or more healthy cows, which has not yet undergone pasteurization or homogenization.
4. Fluid Milk – refers to raw milk received and retained at fresh milk manufacturing plants for pasteurization and distribution, and to the milk delivered to Indulac for production of ultra-pasteurized milk (UHT).
5. Law – refers to Law Act No. 34 of June 11, 1957, as amended.
6. Pasteurization – partial sterilization of milk or milk derivatives in order to destroy objectionable organisms without major chemical alteration of the substance. The procedure is performed with specially designed equipment, installed and operated solely for the purpose of pasteurization.
7. Milk manufacturing plant – establishment where milk is delivered, processed, pasteurized, processed aseptically and/or refrigerated for its distribution and sales.
8. Milk producer – person who operates a dairy farm and sells raw milk to milk manufacturing plants.
9. Ultra-pasteurization – process in which milk is heated to 280° or higher (ultra-high temperature—UHT), for no less than 2 seconds before or after packaging.

SECTION 5. Adoption of regulating principles:

This regulations act adopts the regulating principles and parameters in the judicial order. To this end, we have employed the data presented in the public hearing by the manufacturers' specialists: Dr. Leonardo Giacchino and Dr. Jorge Freyre.

Said regulating principles and parameters are based on the premise that all pricing regulations must be fair and reasonable. As such, all participants in a regulated market must have a right to recover expenses and obtain reasonable returns to justify the investment. In a regulated market, costs must comply with the following:

- A) Expenses must be reasonable, which means they must have been assumed in good faith. All inadequate, unnecessary expenses must be excluded if considered excessive or superfluous.
- B) Expenses must also comply with usefulness. In other words, costs must be indispensable and useful in the production of milk.
- C) Acknowledged expenses must also be discernible and measurable, which means that—in order to be acknowledged by the regulations act—said costs or expenses must be real, legitimate, necessary, and typical of the manufacturing enterprise. They must also be reasonably easy to measure and quantify.

The demands made by the regulating parameters are justified by the fact that the regulated entities are allowed a protected, authorized market. Such a privilege must be reciprocated with a commitment to supply the regulated product in sufficient amounts to recover costs and expenses, plus a reasonable return.

In writing this price regulations act we have also taken into account the suggestion made by the specialists hired by the manufacturers of carefully examining the regulations of similar prices in various states of the United States of America, especially the state of Pennsylvania.

SECTION 6. Regulating expenses or accounts:

A) Producers

We hereby acknowledge as producer expense regulating accounts all the detailed lists that were issued in the update of the Economic Study conducted by the Office of Agricultural Statistics of the Department of Agriculture.

Said study and its update to June, 2007 provide the most accurate data available at the time. Its methodology involved auditing a representative sample of dairy farms, which will produce reasonable, trustworthy data on the producers' operations. To date, we have not had any significant objections to the quality of data in this report. We thus adopt its expense categories. We have also considered other expense entries suggested by the producers' specialists.

Expenses acknowledged in this regulations act, related to the producers' operation, are the following:

1. Feed Concentrate: Refers to the cost or price paid by dairy farmers to feed milk producing cattle, which is essential for producing adequate, competitive milk.
2. Other feed: This refers to the cost of other nutrients used by the farmer to feed the herd.
3. Salaries and day's pay: amount paid by the farmer to the employees of the farm in exchange for their work in the production of milk. If other work—besides milk production—is performed in the farm, which is not directly related to milk production, the amount of salary corresponding to said other activities must be subtracted from the total amount of the expense.
4. Fringe Benefits: Refers to any additional payment the milk producer makes to his or her employees, besides their salaries, such as contribution to private medical insurance, or other similar benefits.
5. Rentals: refers to expenses made to acquire real estate property or any other real property that may be deemed necessary, convenient, and reasonable. Use of said property must be directly related to milk production and the expense must be adjusted accordingly if said property is used for other activities unrelated to milk production.
6. Taxes: State taxes paid by the milk producer, in accordance with fiscal law, are considered expenses.
7. Agricultural machinery and vehicle operation: This expense category refers to expenses paid by the milk producer for the operation of vehicles and agricultural machinery used in the production of milk.
8. Electricity: energy supply to the dairy farm as it appears on the invoice from the "Autoridad de Energía Eléctrica" is acknowledged as an expense, except for the electricity used in other facilities not directly related to milk production.

9. Fertilizer: The cost of fertilizer for the growth and maintenance of pastures in the milk producer's farm.
10. Depreciation: Quantification of deterioration and wear of the equipment and machinery of milk producers is acknowledged as an expense.
11. Medicines: Cost of veterinary products the milk producer purchases to cure and rehabilitate the herd.
12. Repair and Maintenance: Cost of repair and maintenance of equipment in the cow farm and any other equipment used in the producer's farm directly related to milk production.
13. Cleaning Materials: Cost of products and materials purchased by the milk producer to maintain an adequate level of hygiene in his or her dairy farm, as required by the regulations of this administrative agency.
14. Insurance: The total amount paid by the milk producer for insurance against certain risks involved in milk production.
15. Contributions to the Fund for the Promotion of the Milk Industry: The contributions to this fund, created by law, are subtracted from the price paid by the manufacturing plant for milk.
16. Milk transportation: Amount paid by the milk farmer to the manufacturing plant for the transportation of raw milk from the dairy farm to the plant. Said amount is determined by this administrative agency and subtracted by the manufacturing plant from the total amount paid for the milk.
17. Use of cattle: Refers to the cost or expenses for ongoing replacement of cattle, specifically milking cows, to maintain a steady milk production throughout the year. Cattle employed in milk production have a limited productive life and its physiological limitations require that it be rotated constantly to maintain adequate production levels. Milk producers are thus in the obligation of constantly renewing the herd by rearing new calves or purchasing substitutes.
18. Miscellaneous expenses: Refers to minor expenses in which milk producers incur and which are not assigned to the categories listed above. They are acknowledged as expenses as long as they are real, necessary, and reasonable.
19. Financing expenses: Refers to the cost or expense incurred due to the interest rate of financing the maintenance or development of the dairy farm. To be considered an expense, the product of said financing must have been invested entirely in the dairy farm. Any amount of said financing not used for maintenance and improvement of the dairy farm operation must be subtracted proportionately from the interest expense of the loan.

B) Milk manufacturers

We hereby acknowledge as expense regulating accounts for fluid milk producers the accounts presented during the public hearings celebrated on July 31, 2007. Some of the categories presented at the hearing have been combined for the

purpose of simplification; others have been eliminated because they are not applicable.

It must be made clear that milk manufacturing plants manufacture other products not related to milk. In doing so, they use the same facilities and resources that are used for manufacturing milk. For this reason, the expense regulating accounts listed below refer only to the milk manufacturing phase, which requires adequate differentiation of expenses. Strict separation of expenses and costs is one of the objectives of the continuous auditing and regulatory accounting program that will be established under this regulations act.

Expenses acknowledged in this regulations act, related to the milk producers' operation, are the following:

1. Salary and pay: Refers to wages paid to employees exclusively for their milk manufacturing duties. If the employees perform other tasks related to manufacturing products other than milk, the amount corresponding to payment for said tasks must be subtracted from this expense.
2. Payroll taxes: Refers to payments or contributions made by the manufacturing plant which correspond to salary and pay of its employees, according to law. Said payroll taxes will be adjusted proportionately according to the time each employee spends in manufacturing products other than milk.
3. Fringe Benefits: Refers to any additional payment the milk manufacturer makes to his or her employees, besides their salaries, such as contribution to private medical insurance, or other similar benefits. Said expense will be adjusted to account only for the time in manufacturing milk products.
4. Containers (cardboard and vials, plastics and baskets): Refers to the cost of purchasing the containers manufacturing plants use for packaging pasteurized milk, including replacement cost of the baskets used to carry fresh milk. The cost of said containers must equal that of similar industries.
5. Fuel: Refers to the cost of fuels used for machinery and motor vehicles used by the plant for the manufacturing process. Reasonable price for said fuel will be that which prevails in the Puerto Rican market.
6. Maintenance and repair of equipment: Refers to expenses for necessary repair and maintenance of equipment in the manufacturing plant.
7. Electricity: Refers to expenses made by the manufacturing plant paid to *Autoridad de Energía Eléctrica*, the only supplier for electric energy in Puerto Rico. This expense, like all others, will be adjusted to reflect only the electricity used for manufacturing fresh milk. It must be differentiated from the electricity used in manufacturing other products.
8. Water: Refers to the water used by the manufacturing plant, supplied by *Autoridad de Acueductos y Alcantarillados*, for manufacturing fresh milk.
9. Supplies (cleaning, laboratory, and office): Refers to laboratory and office supplies, and cleaning supplies for the manufacturing plant. Said expense entry will be restricted to the supplies used for

fresh milk only, excluding the cost of supplies used for manufacturing other products.

10. Equipment, machinery, and vehicle expenses (including maintenance, repair, and depreciation): Refers to expenses of the manufacturing plant for maintenance of the vehicles used in the fresh milk manufacturing and distribution operations. This expense entry must also be adjusted to include only the expenses related to milk products.
11. Loss: value of the milk lost in the milk manufacturing process—under normal circumstances—according to the parameters set by the milk industry. Any value unreasonably exceeding said parameters will not be acknowledged.
12. Taxes and patents: Refers to payment made by the manufacturing plant for taxes and patents after proportional adjustments excluding manufacture of other products.
13. Insurance: Refers to reasonable expenses made for insurance premiums paid by the manufacturing plant, as compared to similar operations. Whenever said premiums include property, machinery, or equipment used for manufacturing products, other than milk, the amount must be adjusted accordingly.
14. Professional service fees: Refers to expenses made by the manufacturing plant when hiring independent contractors to render certain specialized services that cannot be performed by its administrative personnel. Said expense must be essential and absolutely necessary, and it should be directly related to the milk manufacturing business, and no other products.
15. Communication: Refers to expenses made for telephone services and other communication services which are necessary and convenient for the production and distribution of milk.
16. Building expenses: Refers to expenses made by the physical plant of milk manufacturing plants, as related directly to the production of milk.
17. Bad debts: Refers to loss caused by lack of payment due exclusively to credit sales of pasteurized milk. Said expense will only be acknowledged if it remains within reasonable parameters for similar industries.
18. Financing expenses: Refers to expenses or cost of financing when directly related to the milk manufacturing process.
19. Marketing: Refers to expenses made by the manufacturing plant in marketing activities made exclusively for its milk products.
20. Tolls: Refers to expenses for using certain highways. Said expense must be adjusted according to the proportion of milk to the other products transported on said highways.
21. Return of damaged goods: Refers to the expense or loss of the plant due to returns of damaged goods. This expense is exclusively limited to milk related products and it must be within reasonable parameters for similar industries.

SECTION 7. Determination of profit margin for milk producers and manufacturers; establishment of a reserve fund to compensate manufacturers for losses caused by past regulations, when these are determined by the Court:

It is hereby acknowledged that participants in a regulated market have a right to obtain reasonable profits as a result of their participation in the market. Thus, said profit is determined in terms of percentage for milk producers and manufacturers in Puerto Rico.

The law governing regulation of the milk industry in Puerto Rico imposes upon the administrator of this agency the obligation of taking consumers into account, prior to fixing prices, so that the product—considered essential nourishment—may be sold at a reasonable price if not the lowest possible price, according to the financial situation of consumers. This agency thus imposes that the administrator may adjust the profit margins hereby acknowledged whenever the socio-economic situation of the Island requires it.

A) Producers – profit margin for milk producers is set at 2.5%; calculation based on acknowledged costs.

B) Manufacturers – the profit margin for manufacturers is set at 2.5%, calculation based on acknowledged costs. Milk manufactured for the school cafeteria programs (Programa de Comedores Escolares) will not be acknowledged in the calculation.

Establishment of a reserve fund to compensate manufacturers for losses caused by past regulations, when these are determined by the Court:

In the lawsuit mentioned in Section 3 of this Regulations Act, a provisional court order was issued acknowledging that milk manufacturing plants suffered losses due to the price regulations imposed by this administrative agency. Said court order also determines that these losses must be compensated prospectively in periodic payments.

Because the total sum of said compensation has not been determined by the Court, we hereby create, in virtue of this Regulations Act, a reserve fund for payment of said losses, which will draw from the amount consumers pay for fresh milk. Said contribution will be retained and deposited in a special account at the Fund for the Development of the Milk Industry [*Fondo para el Fomento de la Industria Lechera*], which will be in charge of custody and administration of said special account in compliance with the orders from the administrator of this administrative agency.

SECTION 8. Continuous auditing and regulatory accounting:

By approving and disseminating this Regulations Act, this administrative agency will design and establish a program for continuous auditing of milk producers and manufacturers in Puerto Rico.

To this effect, a program shall be designed in no more than ninety (90) days, and the necessary personnel will be hired to effectively implement it. Costs and expenses of said program will be paid initially from the agency's annual budget and contributions by the Fund for the Development of the Milk Industry, if said entity agrees and approves. If these resources are not enough to maintain the reserve fund program, this administrative agency shall impose a tax to the milk producers and manufacturers, which will be determined justly, considering the financial magnitude of their operations.

Jointly with the continuous auditing program, a detailed regulatory accounting system will be designed, so that producers and manufacturers are

bound to supply the required information uniformly formatted and categorized, allowing for rapid, accurate analysis of the data.

Participation and cooperation of producers and manufacturers in the continuous auditing program and the regulatory accounting system will be mandatory. Thus, non-compliance with the obligations set forth by said program and obligation to report required data, as defined by the regulatory accounting system, will constitute a violation of regulations, subject to penalties established by law.

SECTION 9. Automatic adjustment formula for the price of milk:

Law Act No. 34, of June 11, 1957, (5 LPRA 1107) establishes that this administrative agency is responsible for revising the price of milk—at least once a year—and making the necessary adjustments, according to the increase or decrease in production and operation expenses at all levels. Nevertheless, said annual revision may not be enough in light of unexpected changes in the prices of some key ingredients for the producers and manufacturers of milk. To solve this situation, several jurisdictions of the United States of America have adopted automatic adjustment formulas to compensate for the unpredictable increase of certain costs, which in turn has the advantage of allowing for price updating without having to carry out the long, costly process of periodic price revision. This prevents decreased margins for the participants and losses that would take a very long time to recuperate or mitigate, which could lead to undesirable financial weakening of the industry.

In order to correct this situation definitively and comply with the objectives of this regulations act that each sector recover its expenses and obtain a reasonable return, it is necessary to have a useful price revision mechanism to compensate for the sudden changes in several key products. For this reason, we hereby adopt an automatic adjustment formula, which complies with the following:

- A. It makes financial and accounting sense.
- B. It is easy to understand and apply.
- C. It draws information from the financial statements of the companies in the milk industry and from independent price sources.
- D. It fairly compensates all sectors of the industry with verifiable increases in the prices of the products.

For milk producers, said formula will be used whenever significant changes occur in three of its expense categories:

- A. Cost of cattle feed.
- B. Cost of medications for cattle.
- C. Cost of electricity.

For manufacturers, the formula will be used when sudden changes occur in the following expenses:

- A. Cost of fuel used during transportation and manufacturing phase.
- B. Cost of electricity.
- C. Cost of the resin used in the production of plastic containers.

This administrative agency will review the cost of all the products mentioned above for the producers and manufacturers of milk on a monthly basis and will apply the automatic price adjustment formula when it is deemed that change in cost of any

such products justifies the automatic adjustment in the price of milk provided by the formula.

The automatic price adjustment formula was designed during a study that was commissioned from Advantage Business Consulting, attached to this regulations act and adopted as part of it, especially Section II, titled “Formula for the automatic adjustment of regulated prices for milk to compensate for the price increase of certain products”.

Any necessary additional decision regarding the implementation of this automatic adjustment formula for the price of milk will be made by the administrator of this agency via administrative order or resolution, which will eventually be added to this regulations act as an amendment, after it is duly stated that the order must be permanent.

SECTION 10: Indulac and its role as a balance plant:

This Agency hereby acknowledges that the dairy products manufacturing plant of the Milk Industry of Puerto Rico, Inc. (hereinafter called Indulac) is a balance plant that collects and makes good use of the raw milk surplus generated in the Island during certain seasons, caused by the natural milk production cycles. Said manufacturing plant processes the surplus milk, especially for producing ultra—pasteurized milk (UHT). Said milk requires a different manufacturing process from that of fresh milk, and is aseptically packaged, which increases manufacturing costs, as compared to the cost of fresh milk manufacture. Thus, Indulac cannot pay for its raw material the same price as other milk manufacturing plants, although it manufactures a similar product.

Considering the effects and opinions in the Court Order mentioned in Section 3 of this Regulations Act, we hereby grant and acknowledge credit to the aforementioned milk manufacturing plant for its role as balance plant, as long as the company agrees to purchase, pay, and process all excess milk produced in Puerto Rico, regardless of season, frequency, and amount.

In order to qualify for said credit, Indulac must comply with the following:

A. Indulac will serve strictly as a balance plant within Puerto Rico’s dairy industry.

B. As such, the plant will not develop manufacturing practices or policies for profit accumulation.

C. The plant will operate so that at the end of the operational year there are no excess earnings, except a previously calculated and permissible amount, authorized by this administrative agency, for improvement of its facilities and other expenses or similar investments.

D. Any residual income shall be transferred to the milk producers at the end of the operational year, by way of the Price Stabilizing Fund, Inc., and will result in an adjustment to the cost of raw milk for manufacturing plants, thus reducing the price of fresh milk for consumers.

The credit awarded Indulac for the purchase of raw milk to manufacture UHT milk—if it complies with the aforementioned conditions—will be calculated every two weeks so that it will afford the most benefit to the milk industry, especially the milk producers (who actually grant it) in acknowledgement of its role as a balance plant, which in turn provides them with profits from the milk surplus inevitably caused by nature.

Said credit will be calculated as follows:

A. The following definitions apply to this section:

B.

1. Balance credit per quart – credit per quart for UHT milk production.
2. Total balance credit – total credit given for UHT milk production.

3. UHT Amount – total number of quarts of raw milk retained by Indulac to process into UHT milk.
4. Price of raw milk – price per quart paid by Indulac and milk manufacturers for raw milk.
5. Wholesale price – price determined per quart for all the UHT milk produced by Indulac.
6. Fixed cost – total fixed costs assigned to the production of UHT milk for every two-week period.
7. Variable cost – variable cost per quart assigned to the production of UHT milk every for every two-week period.
8. Indulac UHT cost – cost of production per quart Indulac spends in producing UHT milk. It is the sum of the fixed cost per quart, the variable cost per quart, and the price of raw milk.

B. Indulac will provide ORIL its fixed costs, variable costs, wholesale costs, and amount of UHT milk. ORIL will calculate the total credit balance every two weeks.

C. The calculation will be made as follows:

1. When the amount of UHT milk is greater than zero:

- i. The cost if Indulac's UHT milk will be calculated dividing the fixed cost by the amount of UHT milk, and then adding the variable cost and the price of raw milk.

Formula: $[cost\ of\ Indulac's\ UHT\ milk] = \{[fixed\ cost] / [amount\ of\ UHT\ milk]\} + [variable\ cost] + [price\ of\ raw\ milk]$.

- ii. The balance credit per quart will be the cost for Indulac's UHT milk minus the wholesale price.

Formula: $[balance\ credit\ per\ quart] = [cost\ of\ Indulac's\ UHT\ milk] - [wholesale\ price]$.

- iii. The total credit balance will be the credit balance per quart multiplied by the amount of UHT milk.

Formula: $[total\ balance\ credit] = [balance\ credit\ per\ quart] \times [amount\ of\ UHT\ milk]$.

2. When the amount of UHT milk equals zero, then the credit will be equal to the fixed cost for that period.

Formula: $[total\ balance\ credit] = [fixed\ cost]$

SECTION 11: General Rules:

1. The provisions in this Regulations Act are independent of each other, and any determination of unconstitutionality or invalidity of any of these regulations will not affect in any way the others, which will remain enforced.
2. Any of these regulations may be amended or abolished, and additional rules may be adopted, following the procedures established by law.

Signed in San Juan, Puerto Rico on _____
Date

JUAN R. PEDRO GORDIAN
ADMINISTRATOR

APPROVED on _____
Date

GABRIEL FIGUEROA HERRERA
SECRETARY OF AGRICULTURE