July 7, 2008

California Department of Food and Agriculture
Secretary A.G. Kawamura, and State Board President, Al Montna
California Agricultural Vision 2030
AgVision@cdfa.ca.gov

Dear Secretary Kawamura and Mr. Montna:

Thank you for the opportunity to participate in the California Agricultural Vision 2030. As long time members of the California Dairy Industry, we believe it is vitally important to make crucial changes today order to thrive in the years to come. Therefore, we respectfully submit to you a less regulated alternative to our current highly regulated milk pricing system.

Known as Alternative #4, this idea was borne from the collective minds of our diverse Whey Review Committee group which consisted of John Jeter, Geoff Vanden Heuvel, Scott Hofferber, and Sean Tollenaar. Together, we collaborated on this approach that would encourage competition and value creation while maintaining a regulated system. Please see the documents attached for a detailed description of our vision.

Sincerely,

John Jeter
CEO and President
Hilmar Cheese Company

Geoffrey Vanden Heuvel
California Dairy Producer

WRC (Whey Review Committee) - Alternative #4

11 to 3 vote to ask Secretary of Agriculture Kawamura to explore this alternative further

What is Alternative #4?

- Allows 4B milk to depool and become unregulated at any time in part or in whole
- Quota milk would have to be pooled and pay the regulated price, although a producer could split his milk and have a portion pooled/regulated and a portion depooled/unregulated
- If a plant chose to pool milk, they would have to pay the regulated 4b price, which would be the FO Cl 3 price less $.50/cwt
- No change in Class 1,2,3 or 4a or the way they are pooled

What is Alternative #4 designed to do?

- To encourage competition between regulated, pooled milk and unregulated, depooled milk, like a federal order
- To encourage innovation and value creation
- To keep a regulated system
- To encourage plant capacity, without lowering regulated price
- To acknowledge the basic conclusions of the McKinsey/CMAB Report, yet with another solution

Why make a change like this?

Current California system is not working well because it:

- Disconnects milk from markets, blunting market signals
- Transfers large value from one segment of the industry to another via pooling
- Encourages "margin maintenance"

- Discourages investment in value creation, while encouraging investment in base commodity plants
- Encourages large entities to minimize risk, not invest in value added products that increase markets or add value
- Milk does not clear the market
- Encourages poor business decisions

March 3, 2008

REPORT OF WHEY REVIEW SUB-COMMITTEE HJTV
(Hofferber, Jeter, Tollenaar, Vanden Heuvel)

This subcommittee recognizes the rare opportunity this Whey Review Committee has to dialog freely about the condition of our industry and openly discuss the future of dairy in California. We resolved to be bold in our thinking, realizing the unique opportunity we have right now to take steps toward an economically healthy, mutually beneficial business environment that can survive and thrive through the next generation. We agree that the status quo cannot sustain a viable industry and it is our hope that a new approach to marketing milk can develop from the discussions we have here.

We met as a subcommittee by telephone for one to two hours on each of February 12, 19, 25 and March 3, 2008. All members were present for each of our meetings. In addition, individual members spoke with each other as needed over the term of this assignment. The open lines of communication we established facilitated a high level of discussion and fostered innovative and expansive thinking about the 4b whey factor itself and the systemic problems underlying the regulated pricing system surrounding the 4b formula.

We agree unanimously in our sub-committee that the regulated pricing system as it exists is fundamentally incapable of facilitating economically good business decisions. There is no direct connection between where milk goes and the price the dairy farmer receives for it. The tightness of the system severely mutes economic signals so that the true “fair price” being sought cannot be discovered. We think the minimum regulated price system needs to encourage competition and allow choices to be available in the marketing of milk.

Alternative #4

Current realities:

- California is in a significant plant capacity deficit position.
- The California producer model, which is heavily dependent on purchased feeds, is rapidly removing California producers national dominance as low cost of production leaders. California's practical cost of production could be well approaching several dollars per cwt. higher than their Midwest competition.
- The requirement that all California processors who purchase market milk (Grade A) must pay the regulated minimum price for that milk regardless of whether or not they are a pool plant means that the only current tool to add incentive for additional plant capacity is to discount the regulated minimum price.
- Given the already expensive cost of doing business for processors in California, the **further discount** in the regulated price needed to add incentive for additional plant capacity could amount to more than one dollar per cwt.
- Discounting the regulated price to add incentive for further plant capacity expansion in California has the potential to be very inefficient because:
    1. All processing plants get the increased margin regardless of whether or not they expand capacity. Given that there is a lot of capacity already, the marginal cost to the producer pool of the increased capacity becomes enormous.
    2. That increased margin in and of itself does nothing to encourage the innovation of the processing sector and may discourage it.
    3. Because it is a government granted regulated incentive that is subject to political pressure there is no assured "shelf life" to the policy thereby creating huge risk to processors who are contemplating an expensive plant capacity expansion that needs a return over the long term.
    4. Despite the large regulated margins this would create, the reality of significant month to month changes in the regulated milk price makes development of higher valued non-commodity cheese markets difficult.

As the McKinsey Study pointed out, and as recent events confirm, California needs to consider a new policy:

Proposal:
To create the opportunity for competition for producer milk between the current regulated system and a new unregulated system.

Proposed changes:

- The regulated class 4b price should be directly tied to the FMMO class III price. We would suggest Class III less $0.50 per cwt as the equivalent price.*
- Secondly, a new Section would be added to the Food and Agriculture Code allowing purchasers of class 4b market milk the option to drop out of the regulated minimum price system.

Alternative #4 **(continued)**

What is contemplated here is a scenario where the regulated system would include all class 1, 2, 3, 4a and whatever 4b milk wished to be part of it. The class 1, 2 and 3 revenues would provide sufficient dollars to cover the quota payments for those producers who have quota. Cheese plants would be free to contract for a milk supply from producers and cooperatives outside of the pool, not subject to any minimum price requirements. Such producer milk would have no access to the regulated pool and would have no pool obligations. Cheese plants could establish any number of types of contracts to purchase grade A milk with regards to duration, volume and price. This flexibility would stimulate the opportunity to innovate. However, the cheese plants would have to compete against the regulated system for a milk supply. The regulated system would have the advantage of the inclusion of the higher classes of milk and a higher regulated class 4b price because the plant expansion incentive need not be included in the class 4b regulated price.

The way this system would work in practice is that producers and cooperatives would make a decision about where they wanted to sell their milk. They could contract to sell all or part of their milk to a cheese plant for whatever terms they could mutually agree to. The milk that was sold to the cheese plants under this arrangement would not participate in the regulated pool. The milk that is sold to a buyer on a regulated basis would participate in the pool and producers will be paid the quota and overbase prices out of the regulated pool. A cheese plant could buy both regulated and unregulated milk at the same time. However all milk purchased, both regulated and unregulated, must be sold by contract which would state, at a minimum, volume and price. CDFA will publish on a regular basis (no less frequently than semi-monthly) the total statewide volume and average price at which the unregulated milk supply is being sold.

*We propose the FMMO class III price less $0.50 to account for the California specific cost and distance factors. The FMMO price is a good one to benchmark off of because it is what the competition in the rest of the country is using for a benchmark. The FMMO class III price includes a value for the whey solids stream. The criteria USDA uses to establish the FMMO Class III price mirrors the criteria that must be considered when California establishes its minimum price and therefore a California 4b price that references the FMMO class III price would meet the California statutory requirements.

Upside Potential:

- Creates the opportunity for a much more efficient and effective incentive mechanism for expansion of cheese manufacturing in California through the use of business arrangements that are not legal today
- Greatly increases the ability of the market signals to be transmitted back to both producers and processors
- Enables the regulated price to be higher than is possible in a system where all milk must be regulated
- Facilitates milk price discovery through real-time transparency.

Downside Potential:

- Creates risks both to producers and processors