Hearing Panel Report

Based on a Public Hearing Held
June 1 and 2, 2006

Addressing Pricing Formulas for Classes 2, 3, 4a and 4b
Contained In the
Stabilization and Marketing Plans
For Market Milk for the
Northern and Southern California Marketing Areas

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For Classes 2, 3, 4a and 4b
Based Upon a Public Hearing Held on June 1 and 2, 2006

This Report of the Hearing Panel regarding proposed amendments to the Stabilization and Marketing Plans for Northern California and Southern California (Plans) is based on evidence received into the Department of Food and Agriculture's hearing folder. The folder includes the Departmental exhibits, written statements and comments received from interested parties, written and oral testimony received at a public hearing held Thursday, June 1 and Friday, June 2, 2006, and written post-hearing briefs.

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INTRODUCTION, SUMMARY OF PROPOSALS AND WITNESSES

California Food and Agricultural Code Section 61801, *et sec*., provides the authority, procedures, and standards for establishing minimum farm prices by the California Department of Food and Agriculture (Department) for the various classes of milk that handlers must pay for milk purchased from producers. These statutes provide for the formulation and adoption of Milk Stabilization and Marketing Plans for Market Milk (Plans).

Petition was submitted by:
1. Dairy Institute of California (Institute)

Six alternative proposals were submitted:
2. Western United Dairymen (WUD)
3. Alliance of Western Milk Producers (Alliance)
4. California Dairies, Inc. (CDI)
5. California Dairy Campaign (CDC)
6. Milk Producers Council (MPC)
7. Land O'Lakes (LOL)

Table 1 outlines the proposed changes in the Class 4a and 4b pricing formula components in contrast to the current pricing formulas.

Table 1 - **Summary of Proposed Changes to Class 4a and 4b Pricing formulas with estimates of price impacts for the five-year period January 2001 to December 2005. Price impacts include variable component in some cases.**

	Current	Institute	WUD	CDC	CDI	Alliance	MPC	LOL
Cost Allowances - ¢/lb								
Cheddar Cheese	17.10¢	17.91¢		16.80¢		18.32¢		
SWP	20.00¢	27.42¢				21.06¢		27.42¢
Butter	15.60¢			12.40¢	16.57¢	16.57¢		
NFDM	15.20¢	15.91¢		15.90¢	16.26¢	16.26¢		
fob Adjuster - ¢/lb								
Cheese	2.90¢	2.52¢	2.29¢	0.00¢		1.75¢	1.20¢	
Butter	2.85¢	1.68¢	1.35¢	0.00¢	2.70¢	2.70¢		
Yields and Tests								
Cheese	10.2	10						
Fat	3.72%	3.67%						
SNF	8.80%							
Price Impacts - $/cwt.								
Classes 2, 3, 4a	-	-$0.01	$0.06	$0.08	-$0.13	-$0.13	-	-
Class 4b	-	-$0.36	$0.10	$0.27	-	$0.06	$0.52	-$0.29
Quota and Overbase	-	-$0.17	$0.07	$0.17	-$0.05	-$0.02	$0.24	-$0.13

A total of 25 witnesses testified including the Department's witness:

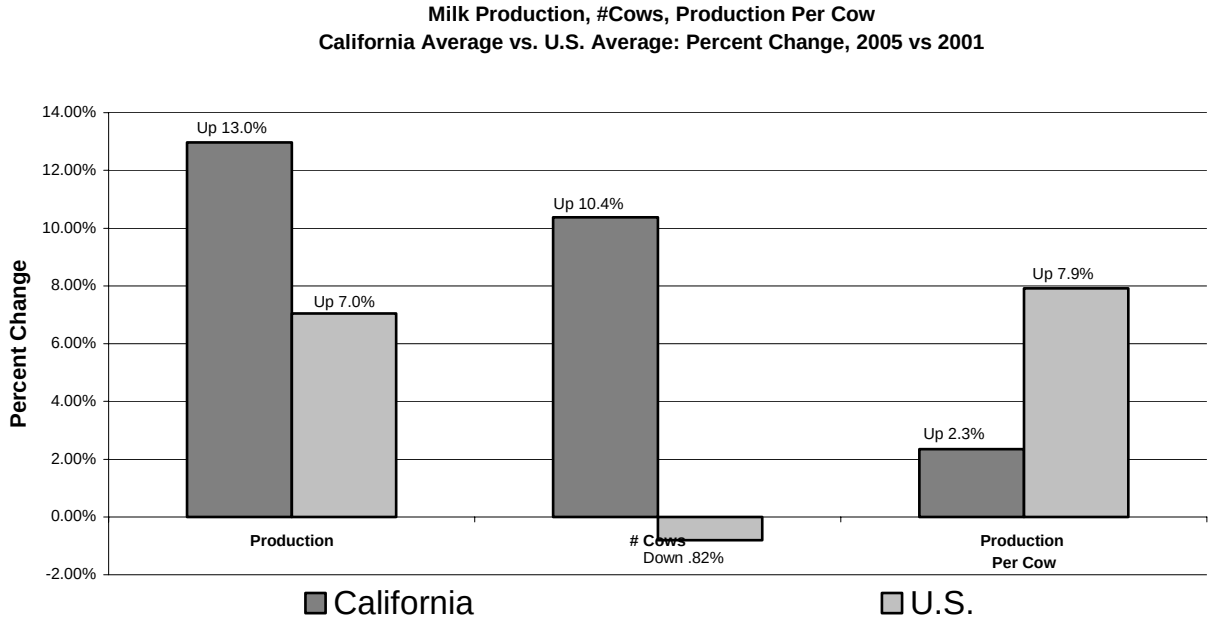
Cheryl Gilbertson — California Department of Food and Agriculture
Joe Augusto, CDC
Domenic Carinalli
Jerry Corda
Richard Cotta, CDI
Greg Dryer, Saputo Cheese
James Gruebele, LOL
Joe Heffington, CDI
Tiffany LaMendola, WUD
Linda Lopes, California Dairy Women's Association
Scott Magneson, CDC
Michael Marsh, WUD
Mike McCully, Kraft Foods
Monique Moretta
Vickie Mulas, Mulas Dairy Company
Albert Nunes
Craig Rasmussen, Blue Ribbon Cheese Company
John Rossi, John Rossi Hay Company, Inc., AMPSI
William Schiek, Institute
Belinda Silva
Ray Souza
Jim Tillison, Alliance
William C. Van Dam, MPC
Case Van Steyn
Geoffrey Vanden Heuvel, MPC
Carl Van Vliet
Tom Wegner, LOL
Mr. Benjamin Yale, Continental Dairy Products

Background: California's Dairy Landscape

The following economic data and statistics represent the current situation of California's dairy industry and were considered when examining and evaluating the proposals and testimony submitted at the hearing.

California Milk Production

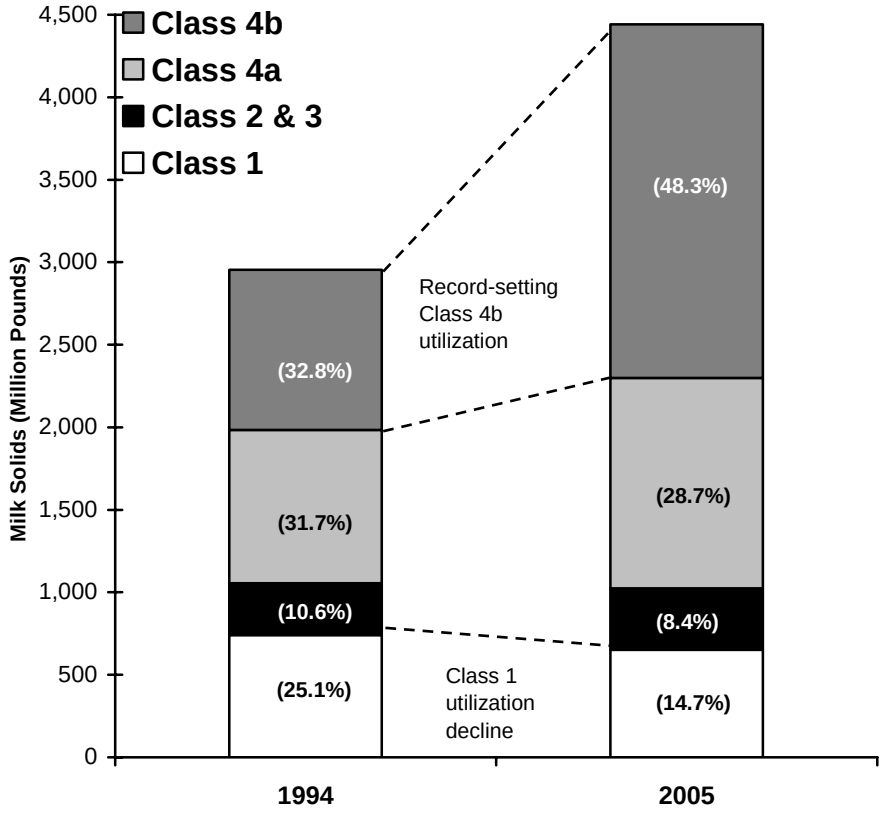
- Annual milk production has increased at an average rate of 4.4 percent over the last 20 years; 4.0 percent over the last 10 years.
- For 2005, milk production reached an all-time high of 37.6 billion pounds, with 11 of the 12 months in 2005 exceeding 3 billion pounds in milk production.
- 2005 showed an overall average increase of 3.0 percent in milk production, compared to the same period in 2004.
- Trend of increasing milk production over the last 20 years:
  - Above 9% - 3 years
  - 5 to 8.9% - 4 years
  - 3 to 4.9% - 7 years
  - 1 to 2.9% - 5 years
  - Less than 1% - 2 years
  - No years recording decrease in milk production
- Following the trend of the last 20 years, milk production could grow between 3.7 and 4.6 percent per year over the next 5 years. This means that by the year 2010, annual milk production in California could be between 45 and 47 billion pounds.



California's Milk Cows

- Annual California cow numbers have *increased* at an average rate of 2.8 percent over the last 20 years; 4.0 percent over the last 10 years – while U.S. cow numbers have *decreased* over the 10 years.
- California has more dairy cows and produces more milk than any other state, yet ranks 7th in milk production per cow, and 7th in total licensed dairies
- Over the last 5 years, the number of dairy cows increased by 232,000 cows

Use of Total Pool Milk Solids in California
By Class, 1994 vs. 2005



California Cheese Production (Class 4b)

- In 2005, 48 percent of California's total milk production was used to produce cheese
- California cheese production set a record in 2005, at 2.14 billion pounds
- California share of U.S. cheese production increased to 23 percent (up from 14 percent in 1995)
- California cheese production has more than doubled in last 10 years

California Butter and Nonfat Powder Production (Class 4a)

- In 2005, 29 percent of California's total milk production was used to produce butter and nonfat powder
- California is ranked first in the U.S. for butter and nonfat powder production with U.S. market shares of 30.6 percent and 43 percent respectively
- Butter has shown an 17.7 percent growth in production over the last 10 years to 408 million pounds in 2005

California Dry Curd Cottage Cheese, Yogurt, Frozen (Class 2 and 3)

- Frozen dairy products have shown slight increases each year over the last 5 years,
- Dry curd cottage cheese production has increased 8.8 percent over the last 5 years
- Yogurt production increased 12.7 percent from 2004 to 2005

Class 1 Sales

- California's share of U.S. population is approximately 12 percent, California's share of U.S. milk production is 21 percent
- Class 1 sales were down 0.2 percent comparing 2005 to 2004
- Only 14.7 percent of California's milk production was used to produce fluid milk products, down from 19 percent just four years ago

Cost of Producing Milk

- Cost figures for January through December 2005 increased $0.49 cents per hundredweight of milk compared to the same period in 2004. All four cost survey areas showed increases in the cost of producing milk with the statewide average cost up 4.1 percent

MANUFACTURING COST ALLOWANCES IN CLASS 4A and 4B PRICING FORMULAS

Issue

This section of the Panel Report speaks only to manufacturing cost allowances (MCA) for butter, nonfat dry milk (NFDM), and Cheddar cheese. The following section addresses the whey factor in the Class 4b pricing formula, including the MCA for skim whey powder (SWP).

California's end-product pricing formulas start with the wholesale prices for Grade AA butter, NFDM, and Cheddar cheese, and subtract a MCA to determine the value (price) for milk. In order to establish MCA for Class 4a and 4b pricing formulas, the Department conducts annual manufacturing cost studies to ascertain processing costs for butter, NFDM, and Cheddar cheese. The Department has a long-standing history of relying on the processing cost study data combined with the relevant economic supply/demand factors to establish MCA for butter, NFDM, and Cheddar cheese.

Once the Department establishes MCA for the three commodities, they remain in the pricing formulas until amended via a new public hearing. At public hearings, interested parties have an opportunity to provide testimony and evidence regarding the manufacturing cost data and any economic factors they believe are relevant in the Department's consideration of appropriate levels of MCA.

Review of Proposals

As at prior hearings on Class 4a and 4b pricing formulas, the level of MCA was a contentious issue. The diversity of testimony offered by producer and processor interests varied widely. There were seven formal proposals to adjust MCA for butter, NFDM, and Cheddar cheese (see Table 2). The differences between the proposals were narrow compared to some prior manufacturing cost hearings. With the exception of butter, the difference between the highest and lowest proposal was 1.5 cent or less. Even proposed changes to the butter MCA primarily focused on two values: 15.6 cents and 16.57 cents.

Table 2 - **Summary of Proposed Manufacturing Cost Allowances (MCA) for Butter, Nonfat Dry Milk (NFDM), and Cheddar Cheese, *as presented at the prehearing workshop***

	Butter ($/lb)	**NFDM** ($/lb)	**Cheese** ($/lb)
Institute	$0.1560	$0.1591	$0.1791
Current	**$0.1560**	**$0.1520**	**$0.1710**
WUD	$0.1560	$0.1520	$0.1710
Alliance *	$0.1657	$0.1626	$0.1832
CDI	$0.1657	$0.1626	n.a.
CDC *	$0.1240	$0.1590	$0.1680
MPC *	n.a.	n.a.	$0.1710
LOL	n.a.	n.a.	n.a.

* Stated MCA are nominal figures as full proposal includes a variable component.

Impact of Proposals

The MCA proposed by CDI and the Alliance would have resulted in the largest decrease in Class 2, 3, and 4a prices, down 13 cents per cwt. The Institute and LOL's proposed MCA would have resulted in the largest decrease in Class 4b prices, down 51 cents and 43 cents per cwt., respectively. The MCA proposed by CDC would have resulted in an increase of seven cents per cwt. in Class 2, 3, and 4a prices, and an increase of three cents per cwt. in Class 4b (see Table 3).

Table 3 - **Summary of Five Year Average Change in Class 4a and 4b Prices resulting from Proposed Manufacturing Cost Allowances (MCA), January 2000 to December 2005, as presented at the prehearing workshop**

Classes 2 3 4a	*($/cwt)*	Class 4b	*($/cwt)*
CDC	$0.07	CDC	$0.03
WUD	$0.00	WUD	$0.00
MPC	$0.00	CDI	$0.00
LOL	$0.00	MPC	$0.00
Institute	-$0.06	Alliance	-$0.18
CDI	-$0.13	LOL	-$0.43
Alliance	-$0.13	Institute	-$0.51

Discussion

California processors testified that the current manufacturing cost allowance (MCA) no longer covers the cost of processing and must be adjusted to provide greater operating margins. Citing the updated annual manufacturing cost of processing data, processors put forth a proposal that they believe would make California products more competitive in the national marketplace.

Dairy producer representatives testified that the proposed increases in the MCA would come at the expense of producers at a time when producers are having difficulty coping with higher production costs and lower prices. Specifically, producer testimony reflected these major points:

- Producers have already borne a significant reduction in their regulated prices to benefit the processing industry.
- Last Class 4a and 4b hearing resulted in an average $0.11 per cwt. reduction in producer prices.
- WUD testified that the Institute proposal could further reduce producer overbase prices by an estimated $0.51 per cwt.
- WUD reported that the testimony reflected overwhelming opposition to the Institute proposals.
- Processors are paying milk prices that are consistently $0.40 per cwt. less than required in federal milk marketing orders.

Alternatively, as discussed below, dairy producer organizations proposed a price floor for butter, NFDM and Cheddar cheese at the federal support purchase price for incorporation

into the Class 4a and 4b pricing formula and proposed that the dry whey factor in the Class 4b price formula be adjusted so that it could not be a negative factor in the price calculation even if the dry whey commodity price falls below the MCA. Producers argued that their proposed changes would establish the safety net farmers need.

Processors responded by testifying that high regulated prices will not result in long-term revenue gain for producers if the price paid to achieve these gains is uncompetitive and nonviable to the dairy processing sector.

The distinctly different approaches and interests from these two perspectives constitute the fundamental policy issue that must be resolved in rendering a fair and appropriate manufacturing cost allowance determination. Despite the vigorous debate over California's future dairy pricing policy – both dairy producers and commodity processors (i.e. for Cheddar cheese, butter and NFDM) face remarkably similar economic conditions. Both are price takers, neither having the market power to control the prices they receive. Both are affected by the national commodity market. The long term economic success of both groups is intertwined. The two different perspectives are really partners. The long term viability of each partner is dependent upon the success of the other partner. The importance of this interdependency is made all the more critical because over 77% of California's pooled production is comprised of Class 4a and 4b products. Obviously, if one group falters, the economic interests of the other will be adversely impacted.

Despite the long term interdependency, the short term viewpoints of both interests are what is at issue. Consequently, the Panel carefully evaluated the debate over the MCA and the appropriate level of Class 4a and 4b prices, while giving thoughtful consideration to the two distinct perspectives.

For over 40 years, the Department has established minimum monthly milk prices via end product pricing formulas. Under the pricing formulas for Class 4a and 4b, it is the interaction of the national supply and demand for dairy commodities (Cheddar cheese, butter and NFDM) that determines the general level of minimum prices. When milk supplies are surplus relative to demand, prices for dairy commodities and the prices for farm milk will be low. When milk supplies are inadequate relative to demand, prices for the dairy commodities and the farm milk will be high.

The operating margins available to processing plants are determined by the Department's establishment of the MCA in the Class 4a and 4b pricing formulas. There is limited opportunity for processors to adjust the operating margin. Butter, NFDM, and Cheddar cheese commodity processors have very little ability to increase the product prices and their operating margins given the competitive national market. While it is possible for processing plants to reduce their operating unit costs to provide some short term relief, any meaningful reduction in unit cost will be reflected in subsequent Departmental manufacturing cost studies and the resulting data would be considered in future hearings as a possible reduction in the MCA.

Contrary to the misperception of some dairy stakeholders, reductions in the milk farm price that correspond to surplus market conditions does not translate into an improved operation margin for dairy commodity processors. Reductions in farm price resulting from surplus market conditions (surplus milk supplies) accrue to the benefit of the basic commodity buyers and seldom enhance the processor's operating margin. This is a key reason why MCA

hearings are so important to cheese, butter, and NFDM processors facing an end product pricing formula.

The relatively high Class 4a and 4b prices in April through December 2005 and the significantly lower Class 4a and 4b prices in 2006 to date were both generated using exactly the same pricing formula. The price levels during both time periods are the direct reflection of the balance between the national dairy supply and commercial demand. Both California and the nation experienced higher production levels and increased cow numbers in 2006 as a result of the higher milk prices in the preceding year.

It must be recognized that it is the collective actions/decisions of dairy producers at the farm level, not the actions/decision of processing plants that determine the size of the nation's total milk supply relative to the nation's commercial demand. Only dairy producers have the collective ability to directly influence the number of cows on dairy farms and the quantity of milk produced. Within the biological framework of a cow's reproductive system, dairy producers directly make daily management decisions that will determine the total quantity of milk produced in the short run. Over the long run, it is again the collective decision by producers that will determine the level of resources committed and the corresponding level of milk supplies produced.

Processing plants can influence the production levels by adjusting premiums they are voluntarily willing to pay above the minimum prices. When milk production is low, they can provide additional premiums to encourage more production. When milk production levels are surplus to commercial needs, they can reduce the premiums they are willing to pay and cap the amount of milk they will accept for processing. All evidence submitted by both producers and processors indicated that the premiums paid by California processors had been reduced from prior levels.

In a regulated market using end product pricing, all the market risks and rewards for equating milk production supply with commercial demand is taken by the producer. When supplies are surplus to the market needs, the producer receives low prices (risks). When the supplies are short the producer enjoys high prices (rewards). When supply and demand are in balance, then the resulting prices would provide reasonable returns to producers. These regulated market dynamics are consistent with fundamental economic theory for basic commodity production under a competitive market system.

The hearing record reflected that both producers and commodity processors have experienced increases in their operating costs since the last hearing in 2005. The cost increases were led by increases in energy, fuel, and labor. The Department's data for milk production costs and manufacturing costs reflected:

- Increased cost of milk production of 5.4 percent from 2004 to 2005
- Increased cost of milk production of 8 percent since from 2003 to 2005
- Increased weighted average cost of processing cheese of 3.69 percent from 2003 to 2004
- Increased weighted average cost of processing butter of 5.31 percent from 2003 to 2004
- Decreased weighted average cost of processing NDFM of 1.10 percent from 2003 to 2004

Based on the Department's impact analysis, the affect of the higher average labor and energy rates for the period January to September 2005 manufacturing costs would have:

- Increased weighted average cost of processing cheese of 1.24 percent
- Increased weighted average cost of processing butter of 1.17 percent

- Increased weighted average cost of processing NDFM of 3.11 percent

Additionally, since energy costs for natural gas and electricity are higher in 2005 and 2006 to date than in 2004, both the milk production and manufacturing costs will be adversely impacted by the higher rates. Given the fact that energy makes up six percent, 26 percent and eight percent of total processing costs for butter, NFDM and Cheddar cheese, respectively, it could be reasonably expected that manufacturing costs will be up in 2005 and 2006. Additionally, since energy made up 2.4 percent of producer costs in 2005, and 2.7 percent in the first quarter of 2006, it could also be reasonably expected that farm costs will be up for all of 2006. Producer and processor witnesses also provided testimony and evidence that the cost of doing business is higher in California than many other major dairy regions of the country that compete with the California dairy industry.

The competitive national market will over the long-term ensure that production costs of the most efficient producers will be covered. The national commodity market will make corrective adjustments to commodity prices that will adequately cover reasonable producer costs as soon as the nation's milk supply comes into balance with the nation's commercial demand.

The end product pricing systems that both California and federal orders use have no similar market correcting mechanism to adjust the operating margin for commodity processors. This is the announced reason that U.S. Department of Agriculture held an emergency hearing in January 2006 to consider proposals that would increase the established MCA. In the same vein, the Panel recognizes the establishment of the appropriate MCA is the single largest determination in whether or not the California commodity processors will have reasonable operating margins to ensure that reasonable processing costs increases are covered.

California's established milk price must allow commodity processing plants to be competitive in the national marketplace. In order to be economically viable, such plants must be able to incur the cost of the raw product (unprocessed milk), the manufacturing costs, and the transportation cost from the plant location to the customer in the national market. California dairy producers and processors have the additional economic burden of having to cope with greater complexity in environmental requirements, lengthy building permit processes, and higher costs associated with capital, land, labor, construction, and taxes to be competitive in the national market.

Major national proprietary cheese companies that are responsible for supplying significant quantities of cheese in the national market constantly are evaluating the comparative advantage of one supply area against the alternatives to ensure that they are cost effective. As the following testimony of the Kraft witness reflected:

> *"Over the last several decades Kraft has shifted its purchases of cheese to the West, specifically California and Idaho, given its advantage in scale and cost. However, over the last one to two years we have shifted purchases away from California. In 2006 we will buy nearly 25 percent less cheddar cheese from California than we did last year. This cheese is now being purchased from Idaho and New Mexico, as it is more competitive than California cheese.*
>
> *Kraft operates four large processed cheese plants in Minnesota, Missouri, Illinois, and Pennsylvania, and partners with co-manufactures with cut & wrap operations an Wisconsin, Ohio, and Mississippi. We evaluate suppliers across the country that can deliver products that meet our specifications and do so at a competitive price. As a supplier to these facilities, cheese plants in the West require a cost structure that enables them to manufacture cheese, ship it several thousand miles, and be priced competitively with locally producing cheese.*

Therefore, it is critical have minimum regulated milk prices that allow for California plants to be competitive with plants in other parts of the country."

While it is commendable that California producers support efforts to keep the regulated milk prices from falling below the cost of production levels, in the short run, these efforts are somewhat misguided. Much of the nation's milk supply is eligible to receive an unregulated price that is based solely on market conditions. Those states that operate under federal orders like Wisconsin and Texas provide the option for the manufacturing plant to opt out of any obligation to pay the federal order minimum price by "depooling." Unlike the federal order system, California processors cannot escape the responsibility from paying the California minimum prices.

It would be doubtful that California producers would want to add this provision to the California system, since it would lower the actual price that California producers receive for their milk supply. The complete analysis is contained in Appendix B entitled: Background issue: California Class 4a and 4b prices relative to Federal Milk Order Class IV and III Prices. The federal provision which provides the ability to "depool" even after the monthly minimum prices are announced makes any comparison between California's minimum Class 4a and 4b prices with federal order prices is misleading. Following Wisconsin and California, Idaho is the largest cheese producer in the nation. Idaho is also totally unregulated by either a state or federal milk marketing order.

While there was widespread disagreement between the producer and processor witnesses over the expansion of manufacturing plant capacity in California, there simply is no argument that the largest cheese processing plants that have been built over the last few years have been in Idaho, Texas, and New Mexico. The Panel does not believe this trend is a mere coincidence with the fact that these states afford a better risk/reward opportunity for manufactured dairy products.

It is common knowledge within the dairy industry and widely reported in national dairy publications that processing plants throughout the nation were running at or near capacity to handle the national milk supply this year. Panel members routinely read the Dairy Market News, Dairy Profit Weekly and other dairy publications that reported:

- More manufacturing plants had switched to making bulk butter to store because they cannot get rid of prints fast enough.
- Cream volumes are moving from one region of the country to another to find willing buyers and processing capacity.
- Current cheese production remains seasonally heavy. In some areas, plant operators were finding it very difficult to sell milk to balance cheese supply with demand.
- Manufacturing plants were operating on extended schedules at or near capacity.
- Surplus milk volume was increasing which tested the manufacturing plant capacities.
- Butter inventories are building as demand slows.
- Class 1 sales declined as schools ended for summer. This forced more milk into manufacturing channels at a time when most cheese and butter/powder plants were full.
- Milk supplies were burdensome in the Midwest with offerings noted at sharp discounts.
- Upper Midwest is seeing milk offered from other regions at discounted levels and plant capacity is being tested.

There was considerable testimony from both producers and processors on whether or not the state had sufficient processing capacity to handle the state's total milk supply.

While the evidence was not conclusive, there was enough testimony and information for the Panel to form a judgment that California's milk supply in the spring of 2006 was at times in excess of the state's ability to process the supply. The daily records submitted by Hilmar Cheese and their testimony was a clear indication that the California industry is reaching a critical point on the capacity issue:

> *"As Director or Procurement at Hilmar Cheese, my staff and I have taken countless distress calls from co-ops and other handlers in California this year looking for a home for milk, and I quote, "at any price." This milk was and is clearly distressed. Dispatchers have told me that they are having to dump milk, that they were shipping as much as they could out of state, and the receiving stations at California plants had waiting times upwards of 10 hours in some cases. Hauling companies have complained to me that their milk trucks are being used as portable milk silos at other plants because those plants were out of room. Dispatchers have shared that they would send more milk out of state, but that so many trucks were tied up trying to get into plants within the State, that there were not enough trucks available to send milk out of state."*

In addition, Crystal Cream and Butter Company, a northern California processor of Class 1, 2 and 3 products, provided further evidence of problems with the adequacy of California's plant capacity:

> *"In February, we discussed our concerns about excess milk with large manufacturers and were given assurances that they would be able to help us out when the need arose. Feeling somewhat comfortable, our first calls went out during Easter vacation in April, only to be met with sizable limitations due to the lack of available processing capacity. We eventually placed some of the milk locally, moved some over 200 miles for processing and worked around the rest, which in turn causes operational and qualitative challenges that we had hoped to avoid.*
>
> *By early May, we were able to anticipate the amount of excess milk we would generate due to schools going out for the summer and the flush volumes expected from our dairies. With this, we combined the cost of disposing of this milk and our bottom line fear that space would simply not be available to handle our excess milk. At that point, we made an extremely difficult decision that was not made quickly nor taken lightly. We notified our dairies they would be held to contract, thereby sharing the burden of excess milk with those who had increased their production over contractual amounts."*

Finally, a major dairy cooperative, California Dairies Inc., has made the commitment to invest $125 million in a new manufacturing plant that will handle 5 million pounds of milk per day, despite the fact that it is not projected to be profitable even at the manufacturing allowances they were seeking. This is an indication of the further production growth that their members are projecting.

California's total number of dairy cows and total milk production has been generally increasing at rates higher than the national average for over 20 years. Even when California's annual percentage increase falls below the national average, the sheer size of the California industry relative to other dairy states, means a small annual percentage increase in California's supply is a significant increase on an absolute basis.

The surplus national market conditions and the outlook for improvement will depend upon the dynamics of unpredictable market factors. While no one can predict with certainty the following specific questions:

- How well will California's milk supply adapt to the new market realities?
- Will cow numbers decrease/increase/ or remain the same?

- How will the consumer demand react?
- Will it remain strong or weaken?

Based on a 20-year trend, the Panel sees little objective evidence that California's milk supply will not continue to increase in the near future. While the size of the increase may vary from year-to-year, it is reasonable to assume that the trend will continue. If California annual production increases ever stopped or reflected decreases, then a hearing could be held to evaluate the new market dynamics of the industry. Given the Panel's strong belief of future production growth, it's not a question of if the milk supply will exceed the State's processing capacity but when will it occur on an ongoing and permanent basis.

Given the statutory requirement that all market milk marketed in California must pay the state mandated minimum price, it is critical that the minimum Class 4a and 4b prices be established at a level that will ensure California's total milk production will "clear the market," by finding a processing plant to take the production. Failure to do so will place pressure on the minimum pricing system. If on the other hand, the prices are set too low, then producers could be adversely impacted if processors do not increase premium levels.

The Panel finds that the Dairy Institute testimony is an accurate reflection of the market dynamics and the current conditions in California:

> *"When regulated prices are set too high, or more specifically when there is not enough of a wedge between the commodity price and the milk price, manufacturing plants have no ability to create the margin they need to operate successfully. If they increased finished product prices to customers, they are in turn reflected in higher commodity prices that then translates through the formula into even higher raw milk prices. The circuitousness pricing formula means that there is no escape for plants from regulatory pricing mistakes. Regulated prices that are too high also artificially stimulate milk production, at least initially, while at the same time the formula's inadequate plant margins reduce the incentive for plants to procure milk. The result is more milk looking for a home in plants that have reduced incentive to buy it.*
>
> *Milk then becomes distressed and must seek a home in unregulated venues outside the state or be dumped, which returns no value to the producer. The consequence of this scenario is for effective or mailbox producer prices to fall below regulated minimum prices, undercutting the milk order price structure. The scenario just described is at least partially reflective of dairy marketing conditions in California this spring."*

In establishing California's minimum milk prices, the Department has statutory mandates to consider all relevant economic factors including, but not limited to:

- For Classes 1, 2, 3, 4a and 4b
  - Reasonable relationship with national product values
  - Farm costs (relative to prices received)
  - Adequate, continuous supply of wholesome milk at reasonable prices to consumers
  - Reasonable relationship among prices
- Additionally, for Classes 2, 3, 4a and 4b
  - Product value
  - Market price of other milk
- Finally, for Classes 4a and 4b
  - Product prices
  - Product yields
  - Manufacturing costs

The mandatory consideration that got the most attention by the hearing participants was the 2004 cost data for processing the raw milk into the finished manufactured commodity product - Cheddar cheese, butter, and NFDM. The Panel has access to both the public and confidential manufacturing cost data for consideration of the hearing recommendations. The Panel carefully reviews this data in developing its recommendations.

Table 4 - **Alternative Approaches to Setting Manufacturing Cost Allowances (MCA)**

		Butter ($/lb)	NFDM ($/lb)	Cheese ($/lb)
Weighted Average Cost x	1.0	$0.137	$0.154	$0.177
	1.1	$0.150	$0.170	$0.195
	1.2	$0.164	$0.185	$0.212
Volume covered =	70%	$0.145	$0.139	$0.173
	80%	$0.159	$0.169	$0.181
	90%	$0.164	$0.181	$0.210
Weighted Average ROI =	5%	$0.136	$0.153	$0.175
	15%	$0.146	$0.165	$0.188
	25%	$0.157	$0.178	$0.201
For Current MCA =		**$0.156**	**$0.152**	**$0.171**
Weighted Average Cost x		1.14	0.99	0.97
Volume covered =		75%	62%	61%
Weighted Average ROI =		24.7%	4.6%	1.9%

Various criteria for establishing the MCA based on the manufacturing cost data have been proposed in hearing testimony. Some of the most significant include:

- Covering a specific percentage of product volume (see Appendix D)
- Covering the same relative return on investment (ROI) for each commodity (see Appendix E)
- Using weighted average cost data as basis (see Table 4)

While the Hearing Panel does not believe that a single approach or analysis can be used to determine the appropriate MCA, it was intrigued when examining the current manufacturing allowances against those three criteria (see Table 4):

With respect to the volume covered by the current manufacturing cost allowances, it appears that:

- 75 percent of the California butter volume is covered by the current allowance,
- 62 percent of the California NFDM volume is covered by the current allowance,
- 61 percent of the California Cheddar cheese volume is covered by the current allowance.

Unlike the return on investment used in the calculation of the individual manufacturing cost studies for each plant, the Panel calculated the weighted average return on investment for the whole commodity industry (separate calculation for butter, NFDM, and Cheddar cheese).

The Panel calculated this return on investment by

- Subtracting the total operating cost (without the inclusion of the calculated return on investment that is typically included in the cost study) from the established manufacturing allowance for each and every plant.
- The resulting margin was multiplied by the number of product pounds produced by that plant,
- the estimated total dollar margin was divided by that plant's asset value,
- the individual determinations for all plants in the cost study were combined

The resulting data is shown in Table 4. What the Panel found quite interesting was the disparity between the weighted average return on investment for butter versus those the other commodities:

- 25 percent on butter
- 5 percent on NFDM
- 2 percent on Cheddar cheese

In addition, comparing the current manufacturing allowance against the weighted average manufacturing cost, the Panel was able to determine how much the allowance was above or below the weighted average cost data. (see Table 4). The Panel found that the current manufacturing cost allowances were:

- 14 percent above the current weighted average butter cost,
- 3 percent below the current weighted average NFDM cost
- 1 percent below the current weighted average Cheddar cheese cost.

In light of the above data analysis; California's expanding milk production; all the economic conditions mentioned previously; the statutory requirements; all the economic factors; and in trying to delicately balance the interest of producers, processors, retailers, consumers, and other interested stakeholders to ensure that the long term interest of the state is served, the Panel believes that the current MCA for butter is appropriate, while the MCA for NFDM and Cheddar cheese should be increased to levels more consistent with butter.

Panel Recommendations

The Panel recommends that:

- no change be made to the butter manufacturing cost allowance,
- the NFDM manufacturing cost allowance be increased to $0.16, and
- the Cheddar cheese manufacturing cost allowance be increased to $0.178 per pound

The relationship of the recommended make allowances versus the three criteria mentioned above are shown below in Table 5.

Table 5 - **Panel Proposals for Manufacturing Cost Allowances (MCA)**

	Butter	NFDM	Cheese
MCA Proposed by Panel =	**$0.156**	**$0.16**	**$0.178**
Weighted Average Cost x	1.14	1.04	1.01
Volume covered =	84%	63%	77%
Weighted Average ROI =	24.7%	11.0%	7.4%

WHEY FACTOR IN THE CLASS 4b PRICING FORMULA

Issue

The concept to include whey in the Class 4b pricing formula has been controversial since it was first raised many years ago. Producers proposed this concept as a means of capturing revenues from whey production. Processors argued against sharing in revenues in a product that was initially a cost to most cheese plants. The cheese processors that had invested significantly in whey processing technology to develop viable products argued it was premature and would discourage plant investments and technology. Additionally, cheese processors that do not process dry whey products sustain costs for disposal of the whey stream.

The issue starts with the nature of cheese production. In the cheese making process, it is impossible to capture all the milk solids (fat, protein, and milk sugars) in the final cheese product. Those solids that are not captured in the finished cheese product are contained in the whey stream that results from the cheese making process. Typically one hundred pounds of farm milk is converted into cheese (about 10 pounds) and the residual solids (about 6 pounds of fat, protein, and milk sugars) are contained in the whey stream.

These solids can be recovered from the whey stream, but it is an expensive proposition. The plants must separate and eliminate the excess fluid carrier (water) from the solids. Consequently, the process of recovering the residual milk solids from the whey stream involves huge dollar investments in technology/equipment and tremendous investment of energy expenses. Because of the economies of scale required, the solids component recovery is economically feasible only for large scale cheese processors.

Cheese processing firms historically disposed of the whey stream as waste rather than take the economic risk of attempting to recover the solids components. Very few dairy companies were willing to make the sizeable investments in facilities and equipment required to try to recover a relatively small value contained in the whey stream.

Over time, the cost of disposing of the whey stream grew considerably. Larger cheese operations that had significant volumes of the whey to dispose of came under increasing environmental regulations and, thus, significantly more costly handling and disposal requirements.

The Department implemented a pricing component (skim whey powder –SWP) for the value added products derived from the skim whey stream as a result of the January 2003 hearing. The pricing component was designed to reflect the value associated with further processing of skim whey.

Contrary to the typical procedure used for butter, NFDM, and Cheddar cheese, the Department had not completed audited cost surveys on skim whey powder (SWP) prior to the January 2003 hearing. Thus, there was no audited manufacturing cost data available on which the Department could rely. Consequently, only the testimony and evidence in the 2003 hearing record that was submitted by hearing participants was available.

Much of the evidence and testimony at the January 2003 hearing was based on evidence presented during previous federal order hearings, or budgeted financial information. There was

great concern that much of the cost information presented during the hearing could not be verified or validated by the Department's manufacturing cost studies. The Department recognized that manufacturing cost studies for SWP would be completed within a year. In the interim, the Department established a MCA that was set at two cents higher than the NFDM manufacturing allowance to offset higher processing costs.

In April 2004, the Department released a summary of SWP processing costs for selected periods between January 2002 and October 2003. The weighted average costs of the four plants studied was well over 26 cents per pound, considerably higher than the current MCA of 17 cents per pound. In fact, none of the audited cost studies reflected costs as low as the 17 cent level. The cost data was used to establish the MCA at 20 cents per pound as a result of the February 2005 hearing.

The manufacturing cost studies for processing whey costs released by the Department in January of 2006 for the period January 2004 through December 2004, reflected a weighted average cost for the three plants studied of $0.2673 per pound. With very few plants processing SWP and no standard for whey protein concentrate (WPC), questions as to whether or not SWP is an appropriate factor for use in the Class 4b pricing formula continue to arise.

Review of Proposals

Table 6 - **Summary of proposals for modification to the Whey Factor in the Product Value portion of the Class 4b Pricing formula**

Current Whey Factor
(Western Dry Whey - $0.20) x 5.8

Institute Proposal for Whey Factor
(Western Dry Whey - $0.2742) x 5.8
until Western Whey falls below $0.2742, then eliminate the Whey Factor

Land O'Lakes Proposal for Whey Factor
(Western Dry Whey - $0.2742 - 50% x [Western Dry Whey-$0.2742]) x 5.8
Note: this is equivalent to (Western Dry Whey - $0.2742) x 2.9

California Dairy Campaign Proposal for Whey Factor
(Western Dry Whey - $0.20) x 5.8
Western Dry Whey is snubbed at $0.20

Milk Producers Council Proposal for Whey Factor
50% of (Western Dry Whey - $0.20) x 5.8, plus
50% of (WPC 34% Price - $0.26) x 1.8
Western Dry Whey and WPC are snubbed at $0.20 and $0.26, respectively

Alliance Proposal for Whey Factor
(Western Dry Whey - $0.2106) x 5.8
Western Dry Whey is snubbed at $0.2106

Impact of Proposals

It is difficult to break down accurately the impact of the multiple changes in the pricing formulas. The proposed changes in the MCA for SWP and the incorporation of a snubber for SWP combined with other proposed changes to the Class 4b pricing formula: f.o.b. price adjuster, yield, indexing etc. Table 7 approximates the impact of just the two factors regarding SWP.

Table 7 - **Summary of Five Year Average Change in Class 4b and Pooling Prices resulting from Proposed changes to the Skim Whey Factor, January 2000 to December 2005**

		Class 4b ($/cwt.)	Overbase Quota ($/cwt.)
Institute	MCA = $0.2742	-$0.43	-$0.20
	No Whey Factor	-$0.15	-$0.07
CDC	Snubber	$0.07	$0.03
	Variable	-$0.07	-$0.03
	Both	$0.00	$0.00
Alliance	MCA = $0.2106	-$0.06	-$0.03
	Snubber	$0.09	$0.04
	Both	$0.03	$0.01
MPC	SWP and WPC	$0.19	$0.09
LOL	MCA = $0.2742	-$0.43	-$0.20
	Mover	$0.14	$0.06
	Both	-$0.29	-$0.13

Discussion

The incorporation of a pricing component to the Class 4b pricing formula to reflect the value that cheese operations earn from their skim whey stream (the residual of cheese production) has not been easy or straightforward. The skim whey stream had historically been a waste by-product of the cheese making process. As the cheese industry matured and environmental regulations became more stringent, the development of whey by-products became more commonplace as a cost minimization strategy. Still, the investments required to process the skim whey stream into value-added products are significant compared to butter, NFDM, and Cheddar cheese (see Table 4). Also, the financial risks for processing the whey stream into a value-added product are considerable.

Unlike Cheddar cheese, butter, and NFDM which have defined standards of identity and fairly uniform processes, whey usages require their own unique processing equipment, processing procedures, with vastly different associated costs. While economies of scale are critical in successful whey operations, the Panel is mindful that an inappropriate decision on this factor can inadvertently make previously profitable whey enterprise a losing proposition should it over stimulate the production for that particular whey product.

There was considerable testimony by producer organizations to continue to keep the whey factor in the formula. Some producer organizations recognized the need to raise the manufacturing cost allowance (MCA), while others recognized that SWP may not be the optimum product to use as a commodity factor in the formula. Processor testimony favored leaving the whey factor in the formula while increasing the MCA, but only on a short term basis. Cheese processors testified to remove the whey factor once the SWP price drops below $0.2742 per pound. Others testified to adjusting the whey factor by including a percentage of another whey product and snubbing the SWP price at the MCA.

The most recent data available to the Department reveals that there are currently sixty-two cheese processing plants in California. Of the sixty-two plants, only eleven (approximately 18 percent by number and 62 percent by volume) process some form of dry whey product. Only four of the eleven plants manufacture SWP. The four plants represent about six and one half percent of the total California cheese industry. The hearing record does contain Departmental cost studies on the processing cost data for three of the four plants that process SWP (approximately 27 percent of the plants that process some form of whey byproducts, by number).

Table 8 - **Weighted Average Processing Costs and Assets per Production by Cost Groups, Based on cost studies for calendar year 2004, released November 2005, revised January 2006**

Commodity	Groups and number of plants		Total Manufacturing Costs per pound of product	Book Value of Assets per pound product	Average Product Pounds per Plant in Group
Butter	Low Cost	4	$0.1231	$0.1096	72,023,185
	High Cost	4	$0.1792	$0.0866	23,709,652
	ALL PLANTS	**8**	**$0.1370**	**$0.1039**	**47,866,418**
NFDM	Low Cost	3	$0.1373	$0.1026	156,004,763
	Medium Cost	4	$0.1734	$0.1618	59,633,004
	High Cost	3	$0.2412	$0.1704	12,950,870
	ALL PLANTS	**10**	**$0.1542**	**$0.1251**	**74,539,892**
Cheddar	Low Cost	3	$0.1709	$0.1469	209,520,101
Cheese	High Cost	4	$0.1963	$0.0658	47,127,006
	ALL PLANTS	**7**	**$0.1768**	**$0.1282**	**116,724,047**
SWP	**ALL PLANTS**	**3**	**$0.2674**	**$0.6846**	**31,090,631**

Whey processing facilities tend to be highly specialized and very capital intensive Table 8). Million dollar capital investments are required to pull the valuable solids from the whey stream. The technology required and the large associated investments often result in most processing operations as being configured (specialized) to produce one type of whey byproduct or another. These whey stream byproduct plants are typically not configured to switch from one type of whey product to another. In more recent years, most companies investing in whey operations have pursued higher value and more sophisticated whey byproducts. These firms were trying to move away from the commodity market and enjoy higher returns and less price volatility.

The protein percentage for WPC ranges from 25 percent to 100 percent (which includes isolates). Unlike Cheddar cheese, butter and NFDM, there is no standard commodity on which the value of all whey by-products are based. With Cheddar cheese, blocks and barrels are traded daily and with butter 25 kg. and 68 lb. size containers are the standard. The diversity of WPC produced appears to be the result of specific customer demand. Plants continue to modify whey products to meet the needs of their customers. (See Table 9)

The three dry skim whey plants surveyed by the Department are relatively small. (See Table 8) As outlined in the 1990 Cornell University study on whey powder production technology, cost and profitability, “costs of whey powder vary considerably depending on the volume and capacity of the plant”. The study also indicated that plant size was by far the most important factor affecting unit costs of production.

Table 9 - **California Dry Whey, Whey Protein Concentrate, and Whey Protein Isolate Production, 2005**

Product (Protein test) 1/	**Human** (million lbs.)	**Animal** (million lbs.)
Dry Whey (12.5%)	119.2	11.7
WPC (25 to 50%)	47.5	9.8
WPC (50 to 100%) 2/	74.7	1.8

1/ Totals do not include: Milk Protein Concentrate, Dry; Milk Protein Isolate, Dry (90% or greater); Delactose Permeate Whey, Permeate, Dry, Finished Product; Reduced Lactose Whey; Reduced Minerals Whey; Concentrated Whey (sweet type, solids); Concentrated Whey (acid-type, solids); Permeate, On or Off Farm UF or MPC by product; Whey Protein Fractions

2/ Includes Whey Protein Isolates (90% to 100%)

The Panel reviewed the following confidential whey cost information and took into account:

- the size of the plants involved,
- the wide diversity of plants,
- California’s capital, utility, and labor costs are generally higher than most other production areas,
- the audited cost data is consistent with the general parameters of the Cornell University’s study, and
- a comparison of California SWP costs to California NFDM costs for plants of similar size.

After reviewing the information, the Panel believes the Department’s cost studies on SWP are accurate, reliable, and consistent with the parameters of the Cornell study.

Although the SWP price is more reflective of a commodity value it does not serve as a reliable value for the variety of whey stream by-products. The WPC market is more proprietary in nature and uniquely produced to address the needs/requirements of the individual customer. Unlike the cheese market in which the price of most cheese is based on the Cheddar cheese price, the WPC prices are independently priced from the SWP price. Although the correlation has improved between the prices of SWP and WPC (32%), it falls far short of the level needed to base a price value.

To help address this issue, Milk Producer Council proposed adding a WPC price as a factor in the calculation of the whey value. However, WPC is processed at various levels of protein in response to the needs of a wide variety of customers. The processing costs associated with higher levels of protein concentrate are significantly different. More importantly, the net returns in processing SWP and WPC are not interrelated.

While there was testimony from industry to incorporate other whey products into the whey factor, the question of how you combine different whey products with different prices and different manufacturing costs were not fully developed. There is also the issue of lactose that is produced when making WPC. The Panel believes it would be far more productive in the long term to consider the adoption of an adjustment to the cheese make allowance to be reflective of the value that whey byproducts generate.

Concepts proposed by producer representatives to implement a price floor (snubber), below which the whey factor cannot drop, greatly magnifies the problem. By implementing this provision the Class 4b price could not reflect the negative values when the commercial price of SWP falls below the cost of manufacturing. This policy could create serious competitive disadvantages for California cheese processors.

The Panel carefully analyzed the impact of including the SWP in the pricing formula for Class 4b Prices. The Panel used the dataset for January 2000 through December 2005, the most complete and current data available. The Panel believes that this data represents the broad spectrum of economic conditions and actual prices that best represents the volatility of the national dairy market. By using the actual commodity prices in effect during that time period and assuming the SWP factor was in effect in the Class 4b pricing formula the Panel calculated the estimated prices that would have resulted in the time period. The Panel believes that the current MCA for SWP is too low. However, increasing the MCA may be more detrimental to producers than removing the whey factor altogether.

The Panel found that in the years of 2001-2004, the removal of the SWP from the Class 4b pricing formula would have resulted in higher Class 4b prices and correspondingly higher pool prices for farmers. During 2005, the inclusion of the SWP into the Class 4b pricing formula would have resulted in lower Class 4b prices and correspondingly lower pool prices. More importantly, the Panel determined that over the five year period, eliminating the SWP from the Class 4b pricing formula would have resulted in higher Class 4b prices and correspondingly higher pool prices for farmers.

Neither the Hearing Panel, nor anyone else can predict the future SWP market or the relative price level, over the long term. Historically, over the long term, dry whey has been among the lowest priced products that can be produced from the whey stream. Since 2004, however, this has not been the case. The Panel finds the testimony of Greg Dreyer, with Saputo Cheese particularly relevant:

> *"Over the long run it is reasonable to assume that dry whey is among the lowest common economic denominators of alternative whey products. Since 2004, however, this has not been the case. High prices driven by increasing export opportunities in the face of sluggish U.S. production have driven prices to remarkable levels. Companies which have structured to produce higher ended WPCs and isolates were unable to switch over to enjoy revenues from the dry whey upsurge. In fact, prices for many of their products were declining while the cost of their milk was rising dramatically in response to the high whey market."*

The Panel is concerned that the Class 4b pricing formula includes SWP, a product that represents a relatively small number of California cheese processing operations (four plants as stated previously). More importantly, it may overly emphasizes the value from the WPC that may be derived while severely understating the cost of processing the product. The Panel's concern is reflected in Mr. Dreyer's further testimony:

> *"In California, Saputo produces WPC of varying protein levels and participates in a venture which produces whey protein isolate. The lactose permeate byproduct from producing WPC in California presents us with a large disposal cost that offsets profits attained from the sale of WPC. Since 2004, we have been unable to attain anywhere near the profits implied for whey byproducts in the Class 4b pricing formula. The difference between 30-cents and 20-cents dry whey markets represent an enormous milk cost increase to a company our size operating in California."*

Clearly, the WPC is the value added product of the whey stream. Yet the Department has little processing cost data for this product. Given the proprietary nature of the manufacturing of whey protein concentrate, the Panel believes it would be very difficult to obtain the voluntary cooperation of cheese plants that produce whey protein concentrates to capture sufficient processing cost data.

While MPC did propose to incorporate a method to capture the WPC, the proposal merely adds to the complexity of the Class 4b pricing formula and creates additional policy dilemmas that generally can only be determined by subjective judgments by the Department, especially a yield, MCA and price for lactose.

As a result of reviewing the testimony and for the reasons outlined above, the Panel continues to support the removal of the whey factor in the 4b pricing formula as it did in the 2005 hearing determinations.

Panel Recommendation

The Panel recommends that the whey factor be removed from the pricing formula. If the whey factor is not removed, the Panel recommends that the cost allowance for whey be raised to $0.267 per pound and at the same time the cost allowance for Cheddar cheese be increased to $.1780 per pound.

F.O.B. CALIFORNIA PRICE ADJUSTERS

Issue

Rather than requiring California Cheddar cheese and butter manufacturing plants to report the monthly prices that they receive for input into the pricing formula calculations, the pricing formulas incorporate the announced national prices established via the Chicago Mercantile Exchange (CME) to calculate the monthly Class 4a and 4b prices. This procedure is far more administratively efficient and enables the establishment of monthly prices on a much timelier basis.

The California Class 4a and 4b pricing formulas adjust the CME monthly prices to reflect the actual prices that California processors receive for the sales of their finished products. In the case of Class 4a, 2.85 cents per pound is subtracted from the CME Grade AA butter price. In the case of Class 4b, 2.90 cents per pound is subtracted from the CME 40 pound block Cheddar cheese price.

In April 2006, the Department distributed a report that reflected the differences between the actual prices that California plants received and the CME prices for Grade AA butter and 40 pound block Cheddar cheese. The report reflected sales data collected for the period January 2004 through December 2005. During this period the California Cheddar cheese processors and the grade AA butter manufacturers were getting 1.68 cents and 2.52 cents less per pound than the CME respectively. Thus, pricing formulas were subtracting a larger adjustment than the actual difference for processors.

Review of Proposals

The Department received a total of five proposals recommending lowering at least one of the price adjusters; including one proposal calling for the elimination of both the Cheddar cheese and Grade AA butter f.o.b. price adjuster. (See Table 10)

Table 10 - **Summary of Proposed Changes to the California Price Adjusters for Butter and Cheese**

	Butter ($/lb.)	**Cheese** ($/lb.)
Current	***$0.0285***	***$0.0290***
Milk Producers Council	No change	$0.0120
Land O'Lakes	No change	No change
California Dairy Inc.	$0.0270	No change
Alliance of Western Milk Producers	$0.0270	$0.0175
Dairy Institute	$0.0168	$0.0252
Western United Dairymen	$0.0135	$0.0229
California Dairy Campaign	$0.0000	$0.0000

Impact of Proposals

The Department's analysis of the proposals to change f.o.b. price adjusters considered the impact to:

- the prices for Classes 2, 3, 4a, and 4b
- the pool prices for quota and overbase

Table 11 - **f.o.b. Price Adjusters: Impact of Proposals on the Various California Milk Classes and Pool Prices Relative to the Current Pricing Formulas**

		Classes 2 3 4a ($/cwt)	Class 4b ($/cwt)	Pool ($/cwt)
Institute	Butter	$0.05	$0.00	$0.02
	Cheese	n.a.	$0.04	$0.02
WUD	Butter	$0.06	$0.00	$0.03
	Cheese	n.a.	$0.06	$0.03
CDC	Butter	$0.12	-$0.01	$0.05
	Cheese	n.a.	$0.29	$0.14
CDI	Butter	$0.01	$0.00	$0.00
	Cheese	n.a.	n.a.	n.a.
Alliance	Butter	$0.01	$0.00	$0.00
	Cheese	n.a.	$0.12	$0.05
MPC	Butter	n.a.	n.a.	n.a.
	Cheese	n.a.	$0.17	$0.08
LOL	Butter	n.a.	n.a.	n.a.
	Cheese	n.a.	n.a.	n.a.

Table 11 shows the impact the proposals would have had on minimum class prices and on pool prices. The analysis assumes that all other factors in the pricing formulas remain unchanged and that the proposals were in effect from January 2001 through December 2005.

Discussion

The CME is the principal source of competitively determined prices for Cheddar cheese and Grade AA butter within the country. It serves as a reference point of comparison to the actual California Cheddar cheese and Grade AA butter prices that California plants receive. Since California processors do not routinely receive CME prices, f.o.b. price adjusters were introduced to equalize what out-of-state processors and California processors receive for their products.

California Price = CME Price – F.O.B. Price Adjuster

The hearing testimony regarding f.o.b. price adjusters revolved around two main issues:

a) the accuracy of the methods used to compile the data that reflects the difference between the actual prices that California plants received versus the CME prices, and
b) the current levels of the f.o.b. price adjusters.

Accuracy of the Methods Used

CDI testified that with respect to the California price adjuster for butter, they believed the Department's sales price audit for 2004 was adversely impacted by:

- including sales exceeding CME prices in the survey results.
- including forward pricing sales in the CDFA reports.

Therefore, CDI suggests using the butter price adjuster of $.0270, the weighted average difference for the 12 months ended December 31, 2005.

After CDFA released the initial exhibit for CME butter prices vs. California butter sales in February 2006, the question was raised as to whether the price adjuster and the data submitted to CDFA by the manufacturing plants, were accurate. In response, the Department conducted a 24-month audit on the butter and Cheddar cheese sales for 2004-2005; the results were released in April 2006 (Table 12).

The audit entailed collecting sales invoices for 25kg/30lb blocks of Grade AA salted butter and “up to 30 days old” mild block Cheddar cheese. The instructions were to audit the final pounds and dollars at which the butter and Cheddar cheese were sold. Any freight cost, inter-company sales, or brokerage fees were to be excluded from the sale of the butter and Cheddar cheese.

It was the result of this audit, specifically the difference between the Department and CDI 2004 audited butter sales, over which CDI expressed concern. The Panel, in order to account for the discrepancy between CDFA and CDI audited figures, conducted an analysis using the 2004 audited data and compared the CDI weighted average price to both the five-plant average and the CME price per month for the same time period. The results of the analysis clearly showed the CDI weighted average was consistent with the five-plant weighted average. And although some prices did exceed the CME price, the differences were statistically insignificant.

The Department does not differentiate between the types of sales data they receive from the manufacturing plants. The data that is collected from the manufacturing plants is by sales invoice date rather than the actual shipment date. And as a result contracted prices can be included in the data for the month in which the contract was made. The method used for gathering data for butter is consistent with that used for both NFDM and Cheddar cheese.

Testimony was also heard recommending a 12-month period to establish the fob price adjuster. The Panel, however, continues to believe the 24-month time period used to collect sales data is the best indicator available to CDFA to determine the price adjuster. The Panel further argues that deviating from the current method of calculating the price adjuster, from hearing to hearing, will result in inconsistent data. Maintaining consistency is important and the 24-month method of compiling data by the Department staff provides the most objective information available on California Cheddar cheese and Grade AA butter sales.

In addition, several witnesses testified as to the most appropriate method for calculating the f.o.b. adjuster taking into consideration a simple vs. a weighted average. In the Panel’s 2005 findings, the Panel felt that using the weighted average would bias the estimator because there is no theoretical reason why one month’s observation of the price difference should be more heavily weighted than another. The Panel reiterates its 2005 recommendation that, “using the weights twice would introduce bias into the estimator.”

Finally, any suggestion or proposal to modify or eliminate the difference between the CME and California price is unfair and inappropriate. To be reflective of prices received by California processors, the pricing formulas adjust the Chicago Mercantile Exchange (CME) prices by including a f.o.b. adjustment, which by their very nature, are not constant over time. Thus, the

Department has a responsibility to assess periodically the level of the adjustment that needs to be included in the pricing formulas. Therefore, the Panel does not recognize the rational of eliminating the f.o.b. price adjuster and has determined there is no alternative but to apply the full difference between the CME and California price.

Current Levels of f.o.b. Price Adjusters

The Department periodically evaluates the f.o.b. price adjusters in the 4a and 4b pricing formulas by comparing them against actual industry sales data. Once the Department establishes the f.o.b. price adjusters for Cheddar cheese and Grade AA butter, they remain in the pricing formulas until they are amended via a public hearing. The current f.o.b. price adjustment levels have been in effect since April 2005.

Table 12 - **Actual Difference between CME Prices and the Prices Received by California Processors for Cheese and Butter between January 2004 and December 2005.**

	Current f.o.b. Price Adjusters (¢/lb)	Actual Average Difference (24 consecutive months)[1] (¢/lb)
Butter	2.85¢	1.68¢
Cheese	2.90¢	2.52¢

[1]Simple average of the monthly price per pound received by each plant and then weighted by sales volume.

The Department's most recent pricing studies demonstrate that the current f.o.b. price adjusters exceed the actual difference between CME prices and the prices that California processors receive for their products. Table 12 demonstrates the fact that the current price adjusters require modification. The Panel's recommendations regarding the level of f.o.b. price adjusters were developed based on this data.

Panel Recommendation

The Panel recommends changing the price adjusters in the 4a and 4b pricing formulas as follows:

a) Decrease the butter price adjuster to $0.0168 per pound
b) Decrease the cheese price adjuster to $0.0252 per pound

FEDERAL SUPPORT PURCHASE PRICES AS PRICE FLOORS

Issue

The federal government has established a national indirect safety net for all milk prices by maintaining a federal price support program. The federal government, via the Commodity Credit Corporation (CCC) stands ready to purchase butter, NFDM, and Cheddar cheese at established support prices that were designed to allow processors to pay producers pre-determined target milk prices. The U.S. Congress has set the target price at a current rate of $9.90 per cwt. of milk testing 3.67 percent fat. The operational mechanics of this federal price support, however, only establishes a “soft” floor, and milk prices do fall below the designated target price. The proposal to add a floor to the pricing formulas would serve to require the pricing formulas to use the higher of the commodity support purchase prices (SPP) or wholesale prices for Grade AA butter, block Cheddar cheese, and NFDM.

From 1973 to 1995 and 2003 to 2005, the commercial prices for Grade AA butter and NFDM were the higher of their commercial prices or respective support purchase prices. The practice of having a price floor for butter and NFDM was eliminated from the formulas in 1995 because the dairy support program was scheduled to terminate. However, the dairy price support program was not terminated and the floors were re-instated from 2003-2005. Since 1989, when the Cheddar cheese price was first used in the Class 4b pricing formula, the price has been just the commercial price, except from 2003 to 2005 when the Cheddar cheese price was the higher of the commercial price or the SPP for Cheddar cheese. All price floors, including cheese, were subsequently removed from the formulas following the February 2005 hearing.

Review of Proposals

The alternative proposals presented by MPC, WUD, CDI, CDC and the Alliance all favored reinstating the commodity support purchase prices as floors. The Institute, LOL and various proprietary cheese processors offered testimony in opposition to the incorporation of floors in the pricing formula.

Impact of Proposals

Several witnesses in support of reinstating the price floors testified to the vital importance of the flooring safety net and the quick rally of low commodity prices following the 2003 ruling which implemented price floors in the pricing formulas, testifying that within days of California’s incorporation of flooring the 4b prices to the federal SPP, the CME Cheddar cheese block price moved up to and then above the SPP.

Witnesses representing the Institute, Leprino, Hilmar, and Farmdale all provided opposing testimony to the price floors. They agreed with the Panel’s previous decision which stated, “California’s incorporation of the price floor places the costs of a federal dairy price support program squarely on the shoulders of California processors. California processors are being asked to guarantee a market value for butter, NFDM, and Cheddar cheese that is not guaranteed under the federal milk marketing order program.”

Table 13 - **Number of times since January 1995 that commodity prices have fallen below the target support purchase prices**

CME Butter Price	1
CWAP NFDM Price	19
CME Cheese Price	11

Table 13 lists the number of times that commodity prices fell below the support purchase price for the period from January 1995 to May 2006. CME butter prices seldom fall below the SPP, while CME cheese prices and NFDM prices fall below the SPP more often. Although NFDM prices fall below the SPP most often, flooring the commodity prices at the SPP would have raised Class 4b prices significantly more than Class 4a prices (Table 14).

Table 14 - **Class price increases as a result of flooring commodity prices at the support purchase prices**

(January 2001 to December 2005)

Class 4a	Class 4b
$/cwt	$/cwt
$0.0004	$0.0369

Discussion

During 1970-80, the structure of the California dairy industry was vastly different. Milk supplies were chronically in surplus conditions. Butter, NFDM, and Cheddar cheese products were routinely sold to the federal government CCC program. In that period of time, California sales to the federal government consisted primarily of butter/NFDM since the California cheese usage was relatively small (in 1982, cheese usage was only 17 percent of the state's total pool production). In 2005, however, Cheddar cheese usage accounted for 25 percent of total cheese production in California, and cheese usage represents 48 percent of the state's total pool milk production.

Butter/powder operations are generally reflective of producer cooperative organizations. While they share profit motives, they must first serve their members needs. It may not be profitable for them to take more milk production, but they will willingly do so if their producer members increase production. The butter/powder production lends itself to sales to the federal government price support program far better than cheese production.

The cheese industry is reflective of proprietary processors. The sole purpose of proprietary cheese processors is the profit motive. These firms compete in a very market oriented system and their focus is on obtaining and keeping commercial accounts. They look for long term relationships with their commercial customers. It would be a competitive disadvantage for them to fail to supply their commercial customers when milk supplies are surplus in order to maximize revenues and sell their cheese products to the federal government. When milk supplies returned to a better balance with commercial demand, there is a risk that the commercial buyer would seek alternative sources that are more dependable and their needs would not be sacrificed for government sales.

It is important to recognize that over half of California cheese production does not have the option to sell to the federal CCC program. The federal purchase program is primarily made available for Cheddar cheese and thus, non-cheddar cheese manufacturers are not eligible to sell into the federal government support purchase program.

Price floors create an artificial price within the market at a level that may be higher than the naturally occurring market price. Price floors are advocated by sellers who have something to sell and feel that the market price is inequitable. California's dairy producers are no exception. However, the producers' economic interests for favorable milk prices must be carefully balanced against the processors' need to remain competitive within national and international commodity markets. For any state with sizable milk production, making effective a support price floor will also result indirectly in benefits to out-of-state competitors. While the out-of-state competitors (both processors and producers) enjoy the benefits of California's support price floor, they will not have to bear any responsibility or burden.

If the price floor is implemented and the market price falls below the support price, then the out-of-state processor has lower raw product costs and could undercut the price of California cheese products to obtain the sales of national cheese buyers. The out-of-state producers would indirectly benefit in having their milk prices buoyed by the removal of the California product from the commercial market. The out-of-state producers would also enjoy the common benefit derived from California support price floors, but would have no program costs or burden to bear.

The Panel believes that California producers would not voluntarily agree to a proposal that would limit or control California production growth if the rest of the nation did not have to bear this burden. California producers would immediately voice their opposition to such a proposal as being unfair burden placed upon them. This SPP proposal would result in exactly the same type of unfair burden on processors and therefore is not in California's long term economic interest.

In addition, as previously stated, federal milk pricing formulas do not incorporate the federal support purchase price as price floors. If the federal order pricing program is not revised on a comparable basis, then over the long term, the continued use of the federal SPP as price floors in California pricing formulas would place California manufacturing plants at a competitive disadvantage in commercial markets nationwide.

If the long term implementation of the price floor limits California products from successfully competing in the commercial market, some California plants might have to curtail their production of manufactured milk products, leading to inadequate manufacturing capacity within California. Without adequate processing capacity, California producers will be forced to consider other alternatives including, but not limited to, processing more butter and powder products and consequently depressing the price of butter and NFDM, shipping milk out-of-state for processing, re-locating their dairy facilities out-of-state, and/or sending cows to slaughter (environmental regulations prevent the old approach of dumping milk). These alternative options will all individually and collectively reduce producers' welfare.

Price supports are a national program - if it is not working in the manner it was intended, then it should be fixed on a national basis. It is the Panel's viewpoint that if the federal system meant for the support prices to be used as true floors, then they would in fact purchase the commodity at the CME to ensure prices never fall below the support levels.

Great care and caution must be exercised in consideration of this program objective given the great uncertainty of the future existence of the federal support purchase program. California dairy industry long term interests would be seriously impacted, should California make effective the SPP floor only to later have the federal government terminate the dairy price support program.

World trade discussions and national farm policy debates also suggest that federal price support program are more tenuous that before. Many federal prices support programs have already been eliminated, and the dairy price support program is categorized under the most severely trade distorting policies according to WTO definitions. There has already been much discussion in the dairy industry and in Congress about the long term viability of the federal price support program.

Table 15 - **Manufacturing Cost Allowance (MCA) reduction as a result of flooring commodity prices at the support purchase prices**
January 2001 to December 2005, $/lb.

	Butter	NFDM	Cheddar Cheese
Five Years	$0.000	$0.000	$0.004
All months when below	$0.003	$0.000	$0.031
Lowest Month	$0.003	$0.001	$0.062

As the previous 2005 Panel report illustrated, even with the support purchase prices as price floors, neither the California Class 4a and 4b prices nor the federal Class III and IV prices are guaranteed to be at or above the $9.80 per hundredweight target support price. Table 16 shows various class prices when butter, NFDM, and Cheddar cheese are at their SPP of, respectively, $1.05, $0.80, and $1.13, with skim whey powder at $0.18 per pound. For comparison at a standardized milk test and not the 3.67% fat at which the support price is announced, the $9.80 per cwt. target price has been prorated to 3.5% fat. The analysis shows that even in the presence of price floors, the federal Class IV price, the California Class 4b price and the California Class 4a price all fall below the federal support price of $9.80.

Commodity support purchase prices have two components: a return to manufacturing plants (manufacturing cost allowance) with the residual value being the price dairy farmers receive. Some of the disparity between the $9.80 per cwt. target support price and the prices calculated in Table 16 stems from the federal government not making changes to the manufacturing cost allowance to reflect the additional costs associated with selling to the CCC.

Table 16 - **Comparison of Minimum Prices when Commodity Prices are set equal to Support Purchase Prices**
($/cwt)

	Support Price		Federal		California	
	@ 3.67 %	*@ 3.5 %*	*Class III*	*Class IV*	*Class 4b*	*Class 4a*
Current formulas	$9.90	$9.80	$9.81	$9.63	$9.30	$9.30

assuming: (1) Whey = $0.1795

(2) Cheese, butter, NFDM = SPP

Several individuals testified that reinstating the price floors would not have a negative effect on processors because the market would see to it that the price level would not drop below support. Witnesses pointed to the price of cheese increasing to above support following the 2003 ruling of adding a price floor to the 4a formula for cheese. The Panel considered this testimony but ultimately acknowledged there was no way to corroborate whether this change in the price was the result of market forces or market manipulation from an individual processor purchasing cheese from the commodity market to minimize losses from having to pay the support price while selling the end product for a price below support.

While many producers testified to the importance of a safety net for producers when prices are low, incorporating the floors in the pricing formula would give producers an artificially high price, effectively muting market signals. The lower the market price falls below the support price level, the less market oriented is the California price - rather than encourage producers to curtail milk production it would actually encourage producers to produce more than they would have under a market price.

Furthermore, flooring the commodity prices at the SPP also reduces the manufacturing cost allowances (MCA). Over five years, the average reduction is negligible for butter and NFDM, but nearly half a cent for cheese (Table 15). More significantly, once commodity prices fall below the SPP, they tend to remain there for more than one month, which may lead to cash flow problems. Short-term cash flow is less of an issue for butter and NFDM processors that may see a MCA reduction of 0.1 cents to 0.3 cents per pound, while cheese processors can see a reduction of 3.1 cents to 6.2 cents per pound.

Panel Recommendation

The Panel recommends not to re-instate the commodity price floors in California’s milk pricing formulas for Classes 4a and 4b.

YIELDS

At the time of the June 1st and 2nd hearing, the Class 4 pricing formulas had five commodity yields. The yields convert commodity prices to component prices; directly for Class 4a and indirectly for Class 4b. At the hearing there was a proposal to change only one of the five yields - the block Cheddar Cheese yield in the Class 4b pricing formula.

Issue

Cheese yield and vat tests for fat and solids–not–fat (SNF) are vital components in the structure of the Class 4b pricing formula. These parameters are reviewed periodically to assess how accurately they reflect cheese industry conditions and whether the current method used to calculate yields is appropriate. In January 2006, the Department released its amended cost study exhibit that included summarized data for cheese yields and cheese vat tests in nine California Cheddar cheese plants.

This is an extremely important issue to stakeholders. Cheese processors argue that it is unfair to establish the cheese yield solely on the milk components they receive and that yields ought to be determined using typical milk from the farm as opposed to the Department policy of basing yields on actual milk used in cheese plants.

Many cheese operations pay premiums outside the state established minimum prices to attract milk with higher yielding cheese components. Adding to the dilemma is the fact that cheese operations routinely add other milk components to fortify the farm milk. The fortification of condensed milk, NFDM and other milk components also boosts the cheese yields. Cheese plants have testified that basing the yield on their milk purchases would in effect be a penalty for attracting the milk with higher cheese yield properties. Conversely, producers argue that as long as the make allowance accurately reflects the costs of these premiums and added components, the cheese plants will not be penalized.

Review of Proposals and Analysis

The Institute proposal was the only one to address a change in the yield calculation and cheese was the only commodity for which a change was proposed. The Institute proposed changing the current yield of 10.2 pounds for cheese to 10.0 pounds based on an alternative calculation using the Van Slyke formula. Although no other proposals suggested a change in the yield, testimony was received both in support of and in opposition to the Institute's proposed change.

Discussion

The proposal from the Institute suggested the more appropriate method to use for calculating cheese yields was to use the theoretical Van Slyke Formula, developed to assist the cheese manufacturing plants with the management of their processing operations. The theoretical model was designed as a measure of attainable in-plant efficiency for converting milk with given compositional properties to so many pounds of cheese. Using the key milk components as the basis, the model estimates the attainable cheese yields. It was not designed as a regulatory tool to establish minimum prices for milk usage.

The Panel believes implementing the Van Slyke formula may confound the issue of determining an adequate calculation for cheese yields, as agreement is not likely to be reached on the appropriate parameters to be used in the formula. The Van Slyke formula relies on an acceptance of 7 parameters including percent fat recovery, percent of protein that is casein, percent casein lost in whey stream, other solids in cheese, desired finished cheese moisture, fat content of vat milk and protein content of vat milk. All of these parameters are subject to interpretation and slight changes in any of the parameter assumptions can have a dramatic effect on the calculated yield. As a result, there is likely to be prolonged debate on appropriate parameter values to use in the formula.

In addressing the issue of typical versus actual milk the Panel continues to support its February 2005 recommendation which stated, “the Panel’s preference, in so far as practical, is to use the actual yield (experience) achieved in actual plant environments in California that is derived from producer milk composition (not from fortified vat yields). This is consistent with the principles followed in other aspects of the pricing formulas. While the theoretical yields have some merit as a theoretical measure of in-plant yield efficiency, the Panel is much more comfortable relying on audited data than depending on theoretical yields.” It is essential that the future modification of the cheese yield be established upon unbiased California-based data.

Moreover, the Panel does not share the view that the purpose of the Class 4b pricing formula is to price “typical” California milk. The purpose of the Class 4b pricing formula is to price milk going into the cheese plants. The payment of premiums to attract bulk milk having higher cheese yielding components can be handled once the premiums and associated milk compositions are determined.

In the event that “typical” milk were used to formulate yields, the question remains, what is typical milk? The Panel continues to believe the study from Dr. Phil Tong at California Polytechnic State University at San Luis Obispo is not representative enough to use in determining yield and questions whether this dated study is representative of the current milk supply. Thus, at this time the Department lacks a good source of reliable data on which to base yields.

In addition, to use the theoretical model (typical milk) in establishing the state wide yield requires the use of protein composition data which is currently unavailable to the Department. The Panel recommends that the Department continue to work with cheese processors to collect good information which could be useful in a theoretical framework.

In making the argument that it is important that the yield used in the pricing formula not be derived from milk that has been *incentivized* through the use of premiums to achieve higher proteins, cheese processors must remember that cheese operations receive substantial benefit from the sharing of pool revenues by all producers. The sharing of pool revenues via the pooling programs, both within California and in federal milk marketing orders, have lowered the prices that cheese processors would have had to pay to acquire milk. Additionally, cheese processors do less balancing of the swings in seasonal demands of the higher priced usages relative to performance of butter and NFDM operations.

The Panel does not feel appropriate and economically rational adjustments can be made to the cheese yield with key gaps in crucial data sets and a lack of consensus amongst industry leaders. Industry stakeholders and the Department must work outside of the hearing process to develop the acceptable parameters needed to calculate an accurate cheese yield for

California. Based on the hearing record, any decision at this time tends to incorporate a degree of subjectivity. Such decision would prolong the long-term debate without providing a step towards long-term resolution.

In the previous decision rendered following the February 1, 2005 hearing, the Panel recommended that the manufacturing cost unit obtain the following data during the next audit cycle of cheese plants:

- fat, protein, and vat fortification costs,
- fat, protein, and other solids tests,
- protein premium data, and
- component values of bulk milk versus the use of filtered and other concentrated milk components in cheese plants.

Thus far the Department has not been able to obtain the requested information. The manufacturing staff must continue to work with cheese plants to obtain the necessary data. Until this data becomes available, however, the Panel feels the current method of establishing cheese yields remains the most appropriate alternative.

In addition, the Panel again recommends that the Department take a leadership role in organizing the Dairy Advisory Committee to explore relevant issues toward developing an appropriate cheese yield. Lack of industry interest after the close of the previous hearing and ex parté restrictions from the opening of a subsequent hearing have precluded the Department from make the intended progress on this issue.

Panel Recommendation

Maintain current yield and test values at 10.2 @ 3.72% fat, 8.80% SNF in the Class 4b formula.

FACTOR FOR WHEY BUTTER IN THE CLASS 4b PRICING FORMULA

Issue

The Class 4b pricing formula contains three factors: whey butter, block Cheddar cheese, and skim whey powder. The first two factors have been part of the formula since 1989; the factor for skim whey powder became a part in 2003. All three factors use manufacturing cost allowances (MCA); none use support purchase prices (SPP).

Originally, the factor for whey butter took the following form:

whey butter factor = [(CME Grade B butter) - MCA] x 0.27

In 1998, the Chicago Mercantile Exchange (CME) discontinued trading Grade B butter. Since Grade B butter had traded about $0.10 below the Grade AA price, the factor for whey butter assumed its current form:

whey butter factor = [(CME Grade AA butter - $0.10) - MCA] x 0.27

The MCA has varied from a low of $0.097 to its current level of $0.156 per pound.

Review of Proposals

MPC proposed a restructuring of the factor for whey butter:

whey butter factor = [Class 4a fat price] x 0.27

MPC stated that because most cheese plants sold their whey cream or whey butter in 1989, the use of an equivalent for the Grade B butter price was appropriate. MPC stated that today, however, most cheese plants use their whey cream to fortify their vats. Thus, the whey cream should be valued at the higher Class 4a fat price.

Impact of Proposals

Had MPC's proposal for the factor for whey butter been in effect for the 60 months ending December 2005, the Class 4b price would have increased $0.09/cwt., with a $0.04/cwt. increase in the quota and overbase prices.

Discussion

The proposal assumes that cheese processors seldom if ever make whey cream butter or sell whey cream. Instead, it assumes that most cheese processors fortify their cheese vat with the whey cream. An examination of the hearing record found little basis for this assumption.

The Panel reviewed receipts and usage for the seven plants that are part of the Cheddar cheese cost study. Of the seven plants, four plants (with 80 percent of the cheese volume) make for sale some whey cream and/or whey butter. Further, at least one cheese processor,

not part of the cost studies, gave evidence that they do not add whey cream back to the vat. Thus, the assumption that most plants add their whey cream back to the vat is not correct.

Additionally, if all cheese processors did fortify their vats with their whey cream, there would be an increased cheese yield and a decreased whey butter yield to zero, not 0.27 pounds per hundredweight.

Finally, the proposal incorrectly combines the whey butter yield (0.27) with the Grade AA butter yield (1.2) to give a total yield of 0.324 pounds of butter per hundredweight of cheese milk (0.324 = 0.27 x 1.2). Proponents gave no justification for a yield of 0.324 pounds per hundredweight.

Panel Recommendations

The Panel recommends that no change be made to the factor for whey butter in the Class 4b pricing formula.

CREDIT FOR CCC SALES OF BLOCK CHEDDAR CHEESE

Issue

The federal government has established an indirect safety net for all milk prices by maintaining a federal price support program. The U.S. Congress has set the target price at $9.90 per cwt. of milk testing 3.67 percent fat. The operational mechanics of this federal price support, however, only establishes a “soft” floor, and milk prices do fall below the designated target price (see Table 17).

Table 17 - **Number of times since January 2000 that Class Prices have fallen below the target support price**

Federal Class III	16	California Class 4b	20
Federal Class IV	4	California Class 4a	7

The federal government, via the Commodity Credit Corporation (CCC) stands ready to purchase butter, NFDM, and Cheddar cheese at established support purchase prices (SPP). These support purchase prices are currently set at $1.05, $1.1314, and $0.80 respectively per pound of Grade AA butter, block Cheddar cheese, and NFDM. The SPP should allow processors to pay producers the pre-determined target milk price of $9.90 per cwt. of milk testing 3.67 percent fat. However, as with the “soft” floor, commodity prices do fall below the designated target support purchase prices (see Table 13).

Recently, USDA has announced changes to streamline the CCC purchasing process, as well as making the requirements more closely adhere to commercial practices. These changes include eliminating outdated packaging requirements and the use of electronic data transmission. Not enough time has passed to see if these changes will prevent commodity prices from falling below the SPP, reduce the frequency, or reduce how far below the SPP that commodity prices will fall.

Review of Proposals

MPC proposed a credit for CCC sales of block Cheddar cheese. They believed that higher Class 4b prices would more than offset monies lost from the credit.

The proponents linked this proposal to their proposals to use the Cheddar cheese SPP as a prices floor and to establish a variable cheese manufacturing cost allowance (MCA). Absent a price floor (see discussion above) and a variable cheese MCA (see discussion below), the credit for CCC sales would not have the proponent’s desired results.

Other witnesses found that this proposal had some merit, but did not support it, either because of objections to the proponent’s total package of proposals or because of the recently announced streamlining of the CCC purchasing process.

Impact of Proposals

It is not possible to make a reasonable estimate of the impact of a credit for Cheddar cheese sales to the CCC. It would be possible to multiply the proposed credit times the historic

volume of block Cheddar cheese sold to the CCC by California plants. However, proponents believed that the proposal would increase sales to the CCC, thus keeping the CME Cheddar cheese price above, or not as far below, the Cheddar cheese SPP. It is not possible to estimate how much block Cheddar cheese plants would sell to the CCC if the credit had been in place.

Discussion

This was an interesting concept that might result in the CME Cheddar cheese price not falling below, or not as far below, the Cheddar cheese SPP. In November 2000, the CME was 7.8¢ below the SPP and 6.2¢ below in March 2003.

This proposal only lowers producer prices if processors take advantage of it. If it is used however, clearing excess Cheddar cheese to the CCC may strengthen the CME price, raising producer prices.

The target support price and CCC purchases are both federal programs. If the programs are not functioning correctly, they should be addressed at the appropriate federal level. A credit for CCC sales of cheese would have the California pricing and pooling system bear the cost of helping producers in the other 47 states. Some of the disparity between the $9.80 per cwt. target support price and the prices calculated in Table 16 stems from the federal government not making changes to the manufacturing cost allowance to reflect the additional costs associated with selling to the CCC.

The Panel needs more discussion on how any proposal of credits for CCC sales in the Milk Stabilization Plans would interact with the Milk Pooling Plan. This would include both legal and administrative issues such as the need for a pool referendum.

Panel Recommendations

The Panel recommends that there be no form of credits for Cheddar cheese sales to the Commodity Credit Corporation.

ADJUSTING THE MANUFACTURING COST ALLOWANCE BY APPLYING THE RATIO OF THE COMMODITY REFERENCE PRICE DIVIDED BY THE PRODUCTION COST

Issue

The Department has established the manufacturing cost allowance (MCA) in the Class 4a and 4b pricing formulas as fixed values since the inception of end product pricing. The fixed values are adjusted only through a public hearing process. The MCA are established based on careful consideration of all economic factors at the time of the hearing. Some of the major economic considerations include, but are not limited to, the cost of manufacturing, cost of milk production, the relationship between California's prices and those in federal orders, the competitive price relationship between California's finished manufactured products and those from competing areas, and the supply and demand situation.

It is the perception of some dairy farmers that the MCA affords the California cheese, butter, and powder processors a more favorable pricing treatment than California dairy farmers. Many of these farmers believe that California's MCA assure all California processing plants a profit and remove all market risks for processing operations. Some producers see the inadequate pricing levels as being caused by California's MCA. Some producer witnesses testified that California's current pricing formulas encourage California plants to continuously seek more milk than the market needs.

CDC offered the indexing proposal as a means of making the MCA more favorable to producer interests.

Review of Proposal

CDC proposed to adjust the established MCA on a monthly basis by multiplying the ratio of the commodity reference price divided by the Production Cost Comparison.

The current monthly price calculation is represented as follows:

Price = Product Price less Manufacturing Allowance X Yield

CDC's proposed monthly price calculation is represented as follows:

$$\text{Price} = \text{Product Price} - \text{Manufacturing Allowance} \times \frac{\text{Commodity Reference Price}}{\text{Production Cost Comparison}}$$

Impact of Proposal

Had the proposed ratio of the Commodity Reference Price divided by Production Cost Comparison been in effect for the 60 months ending December 2005, the Class 4a Price would have been decreased by $0.11/cwt. Over that same time period the Class 4b price would have been decreased by $0.15/cwt.

Discussion

Under California's end product pricing formula for Class 4a and 4b products, the minimum farm price is determined by taking the finished product price of the commodity (Cheddar cheese, butter, NFDM) and subtracting the relevant MCA to determine the appropriate component minimum prices.

National dairy commodity (i.e., Cheddar cheese, butter, and NFDM) prices swing up and down with changes in the dynamic national market conditions. If milk supplies are short, even in small quantities, relative to the needs of the commercial market (demand), the resulting commodity prices will by extremely high. If milk supplies overly respond and become surplus to the quantities needed to satisfy the commercial demand, then milk prices will fall to very low levels and often below the cost of production.

When national milk supplies are surplus to the commercial needs of the national market and the national dairy commodity prices as well as California's minimum Class 4a and 4b prices are low, it is in the short term interest of producers to seek reductions in the MCA. Any proposal that would modify the level would result in increased minimum producer prices.

CDC testified that the adjustments to the MCA should help improve producer income. Yet, the estimated impact over the five year period of January 2001 through December 2005 of applying the ratio of the commodity reference price divided by the production cost comparison would have been contrary to that intent. Rather than making Class 4a and 4b prices more favorable to dairy producers, implementing this portion of the proposal would have actually made the producers worse off than the current MCA. Over the five year period it would have decreased Class 4a Price by $0.11/cwt. and decreased the Class 4b price by $0.15/cwt. When prices were low as in 2002 and 2003, however, producers would have seen price increases.

There appear to be three misperceptions that some producers have about the pricing system.

First, it is important to recognize that the minimum producer prices for Class 4a and 4b utilization are automatically being adjusted on a monthly basis to reflect changes in national supply and demand conditions. Over the long term, national milk production and commercial demand will seek an appropriate equilibrium level and commodity prices will stabilize around an "equilibrium" price.

Thus the dynamics of the competitive national market determines the long term operating margins for dairy producers. Those producers that are successful over the long-term in keeping their production costs at the lowest levels possible and have the financial resources to weather the "economic storms" will prosper.

In sharp contrast, Cheddar cheese, butter and NFDM plants must operate on relatively fixed operating margins. The manufacturing allowances incorporated into California's minimum Class 4a and 4b pricing formulas basically establish the operating margins that cheese, butter/powder plants must stay within. Unlike producers, there are no automatic monthly adjustments to the operating margins of commodity processing plants. The operating margins will not change, until the Department adjusts the manufacturing allowance via the hearing process.

Changes in the national market conditions do not translate into automatic adjustments in the operating margins for the commodity cheese, butter, and NFDM processors. Those changes transfer entirely to the producer price. Since there is very limited means to expand their operating margins for commodity processors, they are adversely impacted by increases in the major input components, like energy, labor, materials, etc.

The inability of the federal order system to make timely adjustments in the federal manufacturing allowance has placed many cheese and butter/powder processors in financial jeopardy. According to the Saputo Cheese witness, this fact has created a substantial number of outright business failures and plant closures across the country.

While smaller specialty cheese or specialty butter/powder firms may be able to justify and obtain higher prices for hand processed specialty products, this flexibility is not available to large scale cheddar cheese, butter, and powder commodity operations.

Additionally, despite the relatively large volume of manufactured product volumes that are produced in California, no California butter or cheese processor is comparable in size and dollar sales as to any of the major buyers of dairy commodity products. Whether it's retail grocery buyers or restaurants, food processing companies or other procurers of these basic dairy commodities, they all have significantly more market power than the processor. The WalMarts, Safeways, Costcos, General Foods, MacDonald's and Taco Bells, simply have significantly greater bargaining and market power relative to California's commodity processors. Consequently, California commodity processors simply do not have the bargaining leverage to dictate the finished product prices.

If a commodity processor fails to maintain a competitive edge over the constant market pressures to control processing costs, improve processing efficiency, and be competitive in the national market, they will not be successful and viable in the long term.

The very nature of California's end product pricing system applies ongoing pressure on California processors to operate efficiently. As an illustration and assuming all things being equal, if a significant proportion of the state's processing cost is reduced from one year to the next, then the routine release of the Department's annual processing cost data will in all probability cause a Departmental hearing to consider adjustments in the make allowance. Based on this data alone, there is reasonable opportunity that this will be sufficient basis for lowering the established manufacturing allowance.

It is evident from this discussion that the very nature of the California's pricing system ensures that producers and processors must compete and continuously improve. Even when California plants are successful in improving their cost efficiencies, this accomplishment will apply new pressures in the form of the establishment of lower MCA in the pricing formulas. In order to ensure long term success and viability, commodity processors like the California dairy farmer must continuously seek to have lower costs than their average California or national competitor. California processors can ill afford to sit back and depend that the Department's manufacturing allowance will ensure that they remain economically viable.

Additionally, by statute the Department must consider both the cost to producer milk and the processing cost to convert farm milk into finished manufactured products. CDC proposal would make monthly adjustments to the manufacturing allowance solely based on the ratio of the commodity prices to the cost of milk production.

Second misperception relates to inadequate pricing levels as being caused by California's MCA.

It is important to recognize that California's pricing formulas which establish the minimum Class 4a and 4b prices are directly impacted by the movement of national commodity prices. It is these national commodity prices that drive the movement of California's Class 4a and 4b Prices. This is evident in reviewing tables 18 and 19. The movement in the annual average minimum price corresponds much more closely to the movement of the commodity prices for butter and NFDM than to changes or levels of the make allowance. During the years 2000 and 2001 the MCA for butter and NFDM remained at the same level, meanwhile the annual average Class 4a price and the commodity prices both increased significantly in 2001 over 2000. This same pattern was reflected in the movement of the annual average Cheddar cheese commodity prices and the annual average Class 4b prices as shown in Table 19.

Clearly, there are national market dynamics and the balance between the national milk supply and commercial demand (consumption) are far more important factors in determining the level of California's minimum Class 4a and 4b prices than the level of California's MCA.

Table 18 **A Comparison of Butter/Powder Make Allowances, Annual Average Commodity Prices and Annual Average Class 4a Price**

Annual	Make Allowance Cents per lb.		Annual Average Commodity price Dollar per lb		Annual Average Class 4a Dollar/cwt
	Butter	NFDM	Butter	NFDM	
2000	9.7	14.0	1,1642	1.0086	11.81
2001	9.7	14.0	1.6597	0.9704	13.53
2002	10.2	16.1	1.1090	0.8990	10.39
2003*	13.2	15.0	1.1441	0.8043	9.78
2004	13.2	15.0	1.8143	0.8301	12.84
2005*	15.6	15.2	1.5528	0.9250	12.50

* The displayed Make Allowance was made effective on April 1 of that year.

Table 19 **A Comparison of Cheddar Cheese Make Allowance, Annual Average Cheddar Cheese Commodity Price, and Annual Average Class 4b Price**

Annual	Make Allowance Cheddar Cheese Cents per lb.	Annual Average Cheddar cheese Commodity Price Dollars / lb.	Annual Average Class 4b Dollar / cwt
2000	16.9	1.1471	9.68
2001	16.9	1.4358	12.65
2002	17.6	1.1844	9.98
2003*	17.5	1.3161	11.23
2004	17.5	1.6467	14.88
2005*	17.1	1.4954	13.70

* The displayed Make Allowance was made effective on April 1 of that year.

Third misperception of some producers is that California's current pricing formulas encourage California plants to continuously seek more milk than the market needs. Basic economic principals can help clarify this misperception. It is the collective decisions of dairy farmers that determine the total amount of milk produced.

Individual dairy farmers seek to maximize their production and minimize their costs. When the collective total production of all dairy farms exceeds the commercial demand however, the market price will fall, often below the cost of production. The individual decision of each dairy farm on how they will respond to the low price will determine whether or not the production supply will come into balance with commercial demand. If enough producers curtail production then the balance can occur relatively quickly.

Since most cheese plants are proprietarily owned and operated, they are in business to make a profit. In order to maximize their returns, cheese plants strive to operate at full capacity. They are not suited for balancing the needs of the fluid market. If milk supplies are short, the only mechanism at their discretion is the granting of premiums above the minimum price. If milk is long, then processors cut the premiums they offer in an effort to stay competitive.

The hearing testimony from both producers and processors reflected that the premiums offered by the cheese plants had been reduced. There was considerable evidence milk supplies had been offered to cheese processors but was not being taken at the current minimum price level.

Under a competitive market, if processors want more milk supplies, then the decision is up to the producer on whether or not to produce more based on the economic reward. If the current farm price is less than the cost of production, then it makes no economic sense for the producer to respond to processor's request for more milk. To do so would hasten the producer's financial demise.

The Panel believes that the California cheese processors reluctance to take on the extra milk given at the current pricing levels reflects the added risk they would incur in the national market. When milk prices are falling, the more milk a plant takes on at the higher price levels, will hurt their ability to offer a competitive finished product price. The Panel strongly believes that if the cheese processors had the same opportunity to depool, in order that they could pay less than the state's minimum price, that more milk would be purchased by California processors. The lower price reduces the risk to the processor, while allowing those farmers with extra milk supplies to market their milk within California.

Butter/powder operations are a little different in that because they are generally cooperatively owned, they serve their producer members. It is no coincidence that many of the state's cooperatives that operate manufacturing facilities are generally not taking on new producer members.

For all the reasons stated above the Panel found no justification to adopt the proposal to apply the index of commodity price relative to production cost.

Panel Recommendation

The Panel recommends that the proposal to index the MCA with the commodity prices divided by the production cost be denied.

INDEXING PROPOSAL
TO AUTOMATICALLY ADJUST ENERGY COSTS
IN THE MANUFACTURING ALLOWANCES

Issue

Since the inception of end product pricing formula, the Department has established the manufacturing cost allowance (MCA) in the Class 4a and 4b pricing formulas as fixed values. The fixed values are adjusted only through a public hearing process. Between January 1980 to May 30, 2006, the Department has adjusted the fixed MCA in the pricing formulas on eleven occasions for NFDM, eight occasions for butter, and six occasions for cheese (from August 1982 through July 1989 the Class 4b price was equal to the Class 4a price). The adjusted rates remained in effect until the Department determined via another public hearing determination that additional adjustments were appropriate.

Over the past several years, energy rates and costs have fluctuated dramatically in relatively short time periods (i.e. on a quarterly and sometimes monthly basis). Energy rates have changed so suddenly that the published annual plant cost study data are not as reflective of the actual processing costs. While the volatile changes in energy rates will eventually be reflected in subsequent annual cost data releases by the Department, neither producers nor processors have shown a willingness to wait until the fluctuating energy costs are eventually reflected in the annual manufacturing cost publication.

For example, the Department's annual manufacturing cost data for 2003 was made available in November 2004. Using the updated lower natural gas rates for September 2003, the Department published the impact of the lower September gas rates on annual 2003 manufacturing costs in December 2004. Producer representatives based their hearing proposals and testimony on the December updates rather than the annual cost study data that was released in November 2004.

While the Department is making every effort to expedite the timeliness of completing the annual manufacturing cost data as soon as possible, the very nature of the energy market and its volatility can never be totally minimized.

Prior to this hearing WUD raised concerns about the Manufacturing Cost annual updates. While almost all the hearing witnesses that addressed the issue favored the continued practice and reliance on updated information and despite the Department's corrective action to (1) withdraw the annual update which was entitled as Adjusted Manufacturing Cost Data (adjusted for September 2005; and January –September 2005) and (2) issue an Estimated Impact Analysis using the same analysis and format used to measure the impact of hearing proposals, WUD testified in opposition to the use of the updated information.

Against this background, the Alliance proposed the adoption of an energy cost index that would automatically adjust the MCA in the Class 4a and 4b pricing formulas to reflect changes in natural gas costs on a monthly basis.

Review of Proposal

The Alliance proposed that the fixed MCA for cheese, butter, NFDM and whey that are incorporated in the Class 4a and 4b pricing formulas be adjusted monthly by an index factor to reflect changes in the natural gas costs.

In its April 27 filing, the Alliance proposed that the monthly index would be calculated by taking the most current monthly United States Natural Gas Industrial Price (as published by the U.S. Energy Information Administration) divided by the United States Natural Gas Industrial Price for the same month in the previous year.

At the June 1 hearing and in its post hearing brief, the Alliance proposed that the monthly index should be calculated by taking the most current monthly California Natural Gas Industrial Price available (published by the U.S. Energy Information Administration) on the 25th of the month divided by the California State Natural Gas Industrial Price for the same month in 2004.

No other proposals to adjust the energy cost via an index were proposed.

Impact of Proposal

The Alliance's original proposal to index the MCA did not contain enough details on the mechanics of specific implementation and the methodology of routinely applying the index. The specific information on the mechanics of the Alliance proposal was not received in enough time for the Department to perform an impact analysis.

Discussion

Motivated by the economic importance of reflecting the most accurate and up-to-date information as possible, and the positive impact this updated information would have on the economic interests of their membership, both producer and processor organizations have used the dramatic changes in energy rates (both increases and decreases) as the basis for seeking public hearings or recommending adjustments to the MCA in the pricing formula.

Dairy processors have sought public hearings or increases in the MCA in the Class 4a and 4b pricing formulas when energy rates have increased dramatically. Dairy farmers have sought public hearings or decreases in the MCA in the Class 4a and 4b pricing formulas when energy rates have decreased dramatically.

The MCA hearings that directly impact the level of Class 4a and 4b prices and indirectly impact the level of Class 2 and 3 prices have become some of the Department's most contentious and emotional pricing hearings. The dramatic fluctuation in energy rates has only intensified the magnitude of the conflict between competing interests at these pricing hearings and made the hearing more complex.

By manipulating the manufacturing cost data time frame, the public hearing process can produce clear winners and losers.

For example, producers can further their economic interests if they can successfully:

- delay the hearing consideration of sudden energy rate increases;
- delay the use of updated energy rates (which reflect sudden increases) in the hearing record;
- expedite hearing consideration of sudden energy rate decreases;
- expedite the use of updated energy rates (which reflect sudden increases) in the hearing record.

While processors can further their economic interests if they can successfully:

- expedite the hearing consideration of sudden energy rate increases
- expedite the use of updated energy rates (which reflect sudden increases) in the hearing record
- delay the hearing consideration of sudden energy rate decreases
- delay the use of such updated energy rates (which reflect sudden decreases) in the hearing record.

This process is neither in the long term interests of producers, processors, nor the California public. The time frame for incorporating the changes in energy costs should be reflective of the actual changes in energy costs. The overall impact of rapidly fluctuating energy rates, both increases and decreases, should be equitable to both producer and processor interests.

The proposal to index the change in energy rates has considerable merit in helping to resolve this dilemma and help make the process more equitable to all parties. While not the same in every aspect, this situation is somewhat akin to the situation the Department found itself during the 1970s relative to the Class 1 pricing formula.

In the early 1970s, the Department established the Class 1 price at a fixed level via the public hearing process. Once the Class 1 price was established via a hearing decision it remained in effect until the Department held another hearing and made separate determinations to adjust the Class 1 pricing level. Volatile and rapidly increasing milk production costs combined with inflationary conditions in the U.S. economy required the Department to hold numerous public hearings, often within short time periods.

During this period, it was not unusual for the Department to announce the hearing decision from one hearing, only to receive a hearing petition for new hearing shortly thereafter. Given the inflationary pressures and rapid increases of input components, the production cost data on which the most recent price level was established was often already out of date by the time the Department was announcing its hearing decisions.

In order to address this issue, a stakeholder study committee was formed. The study committee together with Departmental staff carefully analyzed and evaluated various options for automating the Class 1 pricing formula. It tracked how closely various pricing formula options reflected the actual prices that were in effect prior to the adoption of automatic pricing formula. The committee's openness; its objective analysis; and careful review of all consideration was helpful in forming common consensus of support.

The typical Department impact analysis on proposed changes in the pricing formulas was not performed on the Alliance's proposed energy index concept. Consequently there was very little data that provided estimates of what would have happened if the proposal energy index was in effect during the prior five year period.

Given the financial difficulties that many dairy industry members are facing and the dynamics of the dairy market, the Panel believes it is extremely important that critical data and information should have been available prior to the hearing. The Panel also believes that the type of analysis and study performed prior to the adoption of the automatic Class 1 pricing formula is extremely appropriate prior to the consideration and adoption of a proposed energy index.

While the Alliance proposal would appear to be fairly straightforward, the opportunity for review and discussions by a wider group of interested parties was limited. The Panel believes that this contributed to the relatively weak hearing support by most other dairy stakeholders. Additionally, since much of the hearing testimony was focused on the whey factor in the Class 4b pricing formula, there was very little meaningful testimony on the energy index concept.

The Panel strongly believes the proposed concept has sufficient merit for serious consideration. Nevertheless, it is extremely important that all aspects of an automatic energy index be carefully understood and evaluated prior to its incorporation into the pricing formulas.

The Panel believes the Alliance proposal, as well as any other valid concepts, should be at least analyzed from the perspective of:

- What Class 4a and 4b prices would have been generated during the most recent prior five-year period if the monthly index were in place?;
- How do the energy costs derived using the proposed index compare to the actual energy costs that are reflected in the cost studies?;
- What is the impact of actual energy costs experienced by the processing plants during the five-year period and how does the Alliance proposal compare against those actual costs?
- Identification of any technical changes that would improve the accuracy of the index (manner in which the index is applied, the base on which the energy rates will be adjusted, etc.)

Contrary to the notion that study is akin to terminating this concept, the Panel earnestly believes that the Dairy Marketing staff can move the consideration of this concept forward. The Dairy Marketing staff can generate the basic data and analysis on the estimated impact of the proposed energy index over a prior five-year period and provide information and data that would address the issues discussed previously. The Panel also believes that the Dairy Marketing staff can complete this data analysis within five months of the determination announcement from this hearing.

The Panel recognizes that Dairy Marketing staff resources are already committed to finalizing the July 2006 Transportation Allowance and Credit Hearing and the December 2006 Class 1 Hearing decision. The Dairy Marketing Branch's ability to perform analysis on the energy indexing concept is based on the plan that no other major projects will materialize during the time between July through the end of the year.

Once the analysis on the energy indexing concept is complete, Dairy Marketing staff would be prepared to share the information with the Dairy Advisory Committee (DAC) and other interested parties. It would be important that serious questions or all appropriate analysis is completed before another formal hearing is granted to consider the energy index proposals again.

There should also be some consensus of agreement by producers, cooperatives, and processors as to the policy objectives being sought in the possible adoption of an energy index. The following concepts might serve as few concepts for consideration:

- The energy index will fairly reflect the increases and decreases in the energy rates.

- While the energy index won't completely eliminate the need for periodic hearings, what provisions can be incorporated into the monthly price calculations to reduce the need for frequent adjustments via the hearing process?
- The energy index will cover reasonable adjustments in energy rates.
- The energy index will not harm firms that make sound business decisions to control energy costs nor will it bail out businesses that make poor business decisions that fail to reasonably control increasing energy costs.

Panel Recommendation

The Panel recommends that the proposed energy index not be adopted at this time.

The Panel recommends that the Department, immediately after the announcement of this hearing decision, will:

- Direct Dairy Marketing staff to perform necessary and appropriate analysis as discussed previously on the energy index concept within five months of the determination announcement of this hearing;
- Once the analysis is complete, the public meeting of the Dairy Advisory Committee would be called for the purpose of reviewing the energy index analysis and data;
- Develop consensus among all interested parties on the general policy objectives that is being sought with the implementation of the energy index proposal.

VARIABLE MANUFACTURING COST ALLOWANCE (MCA) FOR CHEDDAR CHEESE IN THE CLASS 4b PRICING FORMULA

Issue

The Class 4a pricing formula has never used a variable manufacturing cost allowance (MCA). From 1989 to 1996, however, the Class 4b pricing formula had a variable MCA for the Cheddar cheese factor. The variable allowance used the ratio of the CME cheese price to the support purchase price (SPP) for cheese:

$$\text{Cheese MCA} = \frac{\text{base cheese MCA x CME cheese price}}{\text{cheese SPP}}$$

Review of Proposals

MPC proposed to reintroduce a variable cheese MCA:

$$\text{Cheese MCA} = \text{base cheese MCA} + 2.5\% \times (\text{CME cheese price} - \text{cheese SPP})$$

The proponents linked this proposal to their proposals to use the Cheddar cheese SPP as a prices floor and a credit for Commodity Credit Corporation (CCC) sales of cheese. Absent a price floor (see previous discussion) and a credit for CCC sales (see previous discussion), a variable cheese MCA would not have the proponent's desired results.

Several witnesses spoke against the concept of any variable MCA. Another witness found that this specific proposal had some merit. They did not support this proposal, however, because of objections to the proponent's total package of proposals.

Impact of Proposals

Had MPC's proposal for a variable MCA for Cheddar cheese been in effect for the 60 months ending December 2005, the Class 4b price would have been decreased $0.07/cwt., with a $0.03/cwt. decrease in the quota and overbase prices.

Discussion

This proposal is similar to what others have proposed for indexing the MCA (see previous discussion). The Panel reiterates its past opposition to variable MCA. "*Arguments*" [in support of a variable MCA] "*contain several flaws in logic. First, a fixed make allowance does not guarantee that all processing costs in all plants are covered. Second, expansion of the milk supply in California is the result of a myriad of factors, not just the fixed manufacturing cost allowance. Finally, the Panel does not agree that the variable manufacturing cost allowance, as proposed, would be in the best interest of the California dairy industry. The variable make allowance, as proposed, would tend to increase farm milk prices when milk supplies are long, giving an economic signal to produce more milk and, thereby, worsening the supply/demand imbalance. Similarly, it makes little economic sense to reduce farm milk prices when milk supplies are either in balance with or short of market demand"* - from Hearing Panel Report addressing pricing formulas for classes 2, 3, 4a and 4b based on a public hearing held on January 29th and 30th, 2003.

Panel Recommendations

The Panel recommends not to adopt a variable Cheddar cheese manufacturing cost allowance.

ANALYSIS AND DISCUSSION OF CLASS 2 AND 3 PRICING FORMULAS

Issue

The Class 2 and 3 prices are calculated by adding specific amounts to the announced Class 4a prices:

- Class 4a price plus $0.82/cwt. for Class 2 price in Southern California
- Class 4a price plus $0.58/cwt. for Class 2 price in Northern California
- Class 4a price plus $0.65/cwt. for Class 3 price in Southern California
- Class 4a price plus $0.64/cwt. for Class 3 price in Northern California

Thus, any change in the Class 4a pricing formula will directly affect the Class 2 and 3 pricing levels. Despite the inclusion of the Class 2 and 3 price formulas as items that would be considered, no formal proposals were submitted for analysis and review at this hearing.

Impact of the Class 4a proposals on the Class 2 and 3 prices

Had the five proposals to amend the Class 4a pricing formula been in effect from January 2001 to December 2005, then on average the Class 4a price and, thus, the Class 2 and 3 prices would have been:

- down $0.13/cwt. with the CDI and Alliance proposals
- down $0.01/cwt. with the Institute proposal
- up $0.06/cwt. with the WUD proposal
- up $0.08/cwt. with the CDC proposal

Discussion

There was little testimony on the Class 2 and 3 pricing formulas. No witness suggested that any change in the Class 4a price not be passed onto Class 2 and 3 prices. Much of the detailed analysis above for Class 4a, however, is also applicable to Classes 2 and 3 (see particularly Tables 1, 3, 10, 11 and 14).

The Panel is concerned with the decline in California's market share of Class 2 and 3 products. California producers and California Class 2/3 processors might be better off if the California Class 2 and 3 prices were more competitive with the regulated prices in other production areas, promoting the expansion of California's Class 2 and 3 usages. Periodic adjustments to the Manufacturing Cost Allowances (MCA) have kept Class 4a and 4b price competitive. Thus, Class 4a and 4b products are expanding relative to other production areas, but uncompetitively priced California Class 2 and 3 products are contracting.

There is no basis in the Hearing record, however, for adjusting the Class 2 and 3 pricing formulas.

Panel Recommendation

At this time, the Panel recommends that the Class 2 and 3 pricing formulas remain unchanged, although any adjustments to the Class 4a pricing formula will result in corresponding changes to the Class 2 and 3 prices.

This Hearing Panel Report has been prepared and submitted by:

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Appendix A

Summary of Proposals

SUMMARY OF PROPOSALS FOR THE MAY 18, 2006 HEARING WORKSHOP — IN PREPARATION FOR THE JUNE 1, 2006 HEARING

Class 4a

Fat = (CME Butter Price - $0.0285 - $0.1560) x 1.2 (Difference between CME & Aver. Price Received by Processors; MCA - Amt. to deduct for Processor's costs; Yield: Lbs. of butter from 1 lb. of fat)

SNF = (CA NFDM Price - $0.152) X 1.0 — (MCA - Amt. to deduct for Processor's costs; Yield: Lbs. of powder from 1 lb. of SNF)

Class 4b

Fat = Class 4a Fat

Product Value = (Cheddar Price - $0.0290 - $0.1710) x 10.2 + (CME Butter - $0.10 - $0.1560) x 0.27 + (Western Dry Whey - $0.20) x 5.8

(Difference between CME & Aver. Price Received by Processors; MCA - Amt. to deduct for Processor's costs; Yield: Lbs. of cheese from cwt. of milk; Difference between CME & Aver. Price Received by Processors; MCA - Amt. to deduct for Processor's costs; Yield: Lbs. of whey butter from cwt. of milk; MCA - Amt. to deduct for Processor's costs; Yield: Lbs. of dry whey from cwt. of milk)

$$SNF = \frac{\text{Product Value} - (3.72 \times \text{Price of Class 4b fat})}{8.80}$$

(Aver. % fat in milk for Cheddar; Aver. % SNF in milk for Cheddar)

INSTITUTE

Class 4a

Fat = (CME Butter Price - $0.0168 - $0.1560) x 1.2

SNF = (CA NFDM Price - $0.1591) x 1.0

Class 4b

Product Value = (Cheddar Price - $0.0252 - $0.1791) x 10.0 + (CME Butter - $0.10 - $0.1560) x 0.27 + *(Western Dry Whey - $0.2742) x 5.8 *Eliminate Whey Factor when falls below $0.2742

$$SNF = \frac{\text{Product Value} - (3.67 \times \text{Price of Class 4b fat})}{8.80}$$

LAND O'LAKES

(Western Dry Whey - *$0.2742 - 50% (Whey-$0.2742) x 5.8

*Adjusting whey factor: + or - 50% of difference between $0.2742 and Dairy Market news published Western Dry Whey price

WESTERN UNITED DAIRYMEN

Class 4a

Fat = (CME Butter Price - $0.0135 - $0.1560) x 1.2

SNF = (CA NFDM Price - $0.152) x 1.0

Floor Butter and NFDM Prices

Class 4b

Product Value = (Cheddar Price - $0.0229 - $0.171) x 10.2 + (CME Butter - $0.10 - $0.1560) x 0.27 + (Western Dry Whey - $0.20) x 5.8

*Floor Cheddar Cheese Prices

CALIFORNIA DAIRIES INC.

Class 4a

Fat = (CME Butter Price - $0.027 - $0.1657) x 1.2

SNF = (CA NFDM Price - $0.1626) x 1.0

Floor Butter and NFDM Prices

CALIFORNIA DAIRY CAMPAIGN

Class 4a

Fat = (CME Butter Price - $0.124*CommRefPrice/COP Price) x 1.2

SNF = (CA NFDM Price - $0.159*CommRefPrice/COP Price) x 1.0

Floor Butter and NFDM Prices

Class 4b

Product Value = (Cheddar Price - $0.168*CommRefPrice/COP Price) x 10.2 + (CME Butter - $0.10 - $0.124) x 0.27 + *(Western Dry Whey - $0.20) x 5.8 *Snub Whey at $0.20

Floor Cheddar Cheese Price

$$SNF = \frac{\text{Product Value} - (3.72 \times \text{Price of Class 4b fat})}{8.80}$$

MILK PRODUCERS COUNCIL

Class 4b

Product Value = (Cheddar Price - $0.0120 - $0.171 - 2.5%*(CME Cheddar-SPP Cheddar)) x 10.2 (Only if CME > SPP) + 4a Fat Price x 0.27 + 50% of (Western Dry Whey - $0.20) x 5.8 *Snub Whey at $0.20 + 50% of (WPC 34% Price - $0.26) x 1.8 *Snub WPC at $0.26

If sales to CCC, processor gets a credit from POOL of $0.038 per pound block sold

Floor Cheddar Cheese Price

ALLIANCE

Class 4a

Fat = ((CME Butter Price - $0.0270 - $0.1657) + Nat Gas Factor) x 1.2

SNF = ((CA NFDM Price - $0.1626) + Nat Gas Factor) x 1.0

Floor Butter and NFDM Prices

Class 4b

Product Value = ((Cheddar Price - $0.0175 - $0.1832) + Nat Gas Factor) x 10.2 + (CME Butter - $0.10 - $0.1657) x 0.27 + ((Western Dry Whey - $0.2106) + Nat Gas Factor) x 5.8 *Snub Whey at $0.2106

Floor Cheddar Cheese Price

Appendix B

Background issue: California Class 4a and 4b prices relative to Federal Milk Order Class IV and III prices.

While the following discussion does not relate to a Hearing issue that requires Departmental action, it was the focus of considerable attention and testimony. The following review will be helpful in (1) understanding the Panel's consideration of the issue and (2) serving as a foundation for the Panel's recommendations.

Producer and processor representatives routinely debate the differences between California's Class 4a and 4b prices compared to federal order Class IV (milk used for butter/NFDM) and Class III (milk used for cheese) prices. In general, producer representatives advocate eliminating or narrowing the gap between the California and federal order prices for reasons of producer equity. Dairy processor representatives advocate maintaining or expanding the gap between the California and federal order prices for competitive reasons.

A major difference between the federal milk marketing order and California's milk marketing system is the ability of manufacturing processors (cheese, butter/NFDM plants) to de-pool in the federal system. Whenever the processing plants voluntarily elect to de-pool in the federal system, the plants are not required to pay the minimum Class III or IV prices established by the federal milk marketing order. This authority is granted to proprietary processors and the election time can be well after the minimum Class III, IV prices, and the federal order pool blend prices are announced. California statutes provide no similar flexibility; all Grade "A" milk purchased by processors, whether the manufacturing plant operates within the pool or separately from the pool (de-pooled), must purchase the milk at state established minimum Class 4a or 4b prices.

Kraft, which operates processing facilities across the nation in both federal milk marketing orders and in California, testified to the inherent disadvantage that California processors must compete with due to this difference in pricing structure. Kraft went on to testify that manufacturing plants, particularly cheese plants, operating in federal orders contract with dairy farmers to pay the federal order blend price. Whenever the federal order Class III price exceeds the federal order blend, the plant de-pools and pays the lower federal order blend to purchase the bulk milk.

The Panel examined the producer price data in the Pacific Northwest Federal Order during those occasions that the federal Class III price exceeded the order's blend price. The data demonstrated that when the price relationship favored de-pooling, dairy farmers received at most the blend price.

Comparison of the California Class 4a and 4b prices to the federal order Class IV and III is inappropriate if processors operating in federal orders are not required to pay the federal order prices. Based on the hearing testimony of various witnesses, most manufacturing plants operating in federal orders enter contracts with dairy farmers to pay the federal order blend price. Setting aside all other economic factors, a more appropriate comparison of farm milk prices between the California and the federal order systems would logically contrast California's Class 4a and 4b price with the federal order blend price.

If the California system allowed processing plants to de-pool, then it would be more appropriate to compare the milk prices between the two systems. Even if the issue of de-

pooling were ignored, different supply/demand patterns and market structure between California and a particular federal order, would exert economic pressure on the relative milk price levels. California's 20-year trend of expanding milk production, lower production costs, greater distance to national markets, and the continuing need to increase processing capacity relative to expanding production is quite opposite the economic conditions in most federal milk marketing orders. While the Upper Midwest is often cited as comparable, this region has had a historical overcapacity of processing facilities relative to its total production. Moreover, this region's production growth has historically been far below most Western milk producing regions.

Comparing California's minimum prices with a production region in the U.S. that is more similar in market characteristics is a more appropriate comparison. The Idaho milk production region is more directly comparable to the California market than most federal order areas. Consequently, a comparison of California's Class 4a and 4b prices with the Idaho market would be more appropriate than with the federal order blend price. Unfortunately, the farm milk prices that Idaho processing plants pay to purchase milk for use in butter, NFDM and Cheddar cheese products are not published or made public.

In addition to production costs versus minimum milk prices, rate of production increase, total milk supply, the state's plant capacity, combined with other relevant economic factors, the Department's manufacturing cost study data has been one of the key considerations in the establishment of minimum Class 4a and 4b milk prices. The cost studies are based on the California plant operations providing the most accurate and most applicable data of the processing conditions unique to California. The federal milk marketing order system does not perform similar cost studies of manufacturing plants to compile processing costs. Thus, other than the California manufacturing cost studies that are routinely made a part of the federal milk marketing order hearing record, the federal system must depend upon the testimony and evidence of industry participants (each with their own vested financial interest), to base adjustments of manufacturing cost allowances in their pricing formulas.

The Panel recognizes the gap between the California Class 4a and 4b prices relative to the corresponding federal order Class IV and III prices. The size of the gap is not the focus or objective of the Panel. The Panel believes it is more important to set as accurate a pricing formula as possible that reflects full consideration of all the key economic factors impacting the California milk market. An accurate pricing formula would consider among other relevant economic factors: milk production costs, milk supply, manufacturing costs, product yields in converting bulk milk into finished products, markets for California commodities, transportation costs, the competitiveness of California commodities compared to other major supply regions, the prices received by California processors for the finished commodities, the state's processing capacities, etc.

Appendix C

Summary of Panel Recommendations

1. **Federal Support Purchase Price as a Price Floor -** Should floors be implemented for Cheese, Butter, NFDM and Whey?
   Panel Recommendation: The Panel recommends not implementing the commodity price floors into the pricing formula.

2. **f.o.b California Price Adjusters-** Should the price adjusters for Butter and Cheese be changed?
   Panel Recommendation: The Panel recommends changing the price adjusters in the Class 4a and 4b pricing formulas as follows:
   - Decrease the butter adjuster from $ 0.0285to $0.0168
   - Decrease the cheese price adjuster from $0.0290 to $0.0252 per pound
   These decreases reflect the simple average of the audited CME Cheddar cheese prices vs. the audited California Cheddar cheese sales date for 24 months (January 2004 through December 2005).

3. **Manufacturing Cost Allowances-** Should any of the make allowances (Butter, NFDM, Cheese and Whey) be changed?
   Panel Recommendation: The Panel recommends changing the make allowances as follows:
   a. Increase the make allowance for cheese from $0.1710 to $0.1780 per pound
   b. Increase the make allowance for NFDM from $$0.152 to $0.160 per pound
   c. No change be made to the make allowance for butter

4. **Indexing-** Should indexing be introduced into the pricing formulas?
   Panel Recommendation: The Panel does not recommend implementing any of the indexing proposals at this time. Further review and analysis of indexing options is needed before implementing indexing into the pricing formulas.

5. **Yield and SNF%-** Should the yield for Cheddar Cheese be changed?
   Panel Recommendation: Maintain the current yield and test values at 10.2@ 3.72 %fat, 8.80% SNF in the Class 4b formula.

6. **Whey Factor-** Should the whey factor be removed from the pricing formula?
   Panel Recommendation: The Panel recommends that the whey factor be removed from the pricing formula. If the whey factor is not removed, the Panel recommends that the cost allowance for whey be increased to $0.267 per pound and at the same time the cost allowance for cheese be increased to $.1780 per pound. The manufacturing cost allowance of $0.267 for whey covers the costs associated with two of the whey plants in the cost study.

Price Effects of Panel Recommendations

Had the Panel recommendations been in effect from January 2001 to December 2005, the five-year average annual revenue impact would have been:

- down $0.02/cwt for Class 2, 3 and 4a prices;
- down $0.19/cwt for Class 4b prices; and
- down $0.09/cwt for Quota and Overbase prices.

Note: The supply/demand conditions that existed during the 2001-2005 period may or may not be the same conditions that will occur in the future.

Appendix D

APPROXIMATE PERCENT VOLUME OF BUTTER, NONFAT DRY MILK, CHEDDAR CHEESE AND SKIM WHEY POWDER COVERED BY VARIOUS POSSIBLE MANUFACTURING COST ALLOWANCES

Based on cost studies for calendar year 2004, released November 2005, revised January 2006

Manufacturing Cost Allowance ($/lb)	Percent Volume Covered for this Allowance			
	Butter	Nonfat Dry Milk	Cheddar Cheese	Skim Whey Powder
$0.10	0%			
$0.11	42%			
$0.12	42%			
$0.13	42%	0%		
$0.14	48%	62%		
$0.15	75%	62%		
$0.16	83%	62%		
$0.17	96%	82%	0%	
$0.18	96%	86%	76%	
$0.19	96%	93%	86%	
$0.20	96%	93%	89%	
$0.21	96%	93%	100%	
$0.22	96%	96%		
$0.23	98%	99%		
$0.24	98%	99%		0%
$0.25	98%	99%		54%
$0.26	98%	99%		54%
$0.27	98%	99%		80%
$0.28	98%	99%		80%
$0.29	98%	99%		80%
$0.30	98%	99%		80%
$0.31	98%	99%		80%
$0.32	98%	99%		80%
$0.33	98%	99%		80%
$0.34	98%	100%		100%
$0.35	98%			
$0.36	98%			
$0.37	98%			
$0.38	98%			
$0.39	100%			

Appendix E

APPROXIMATE RETURN ON INVESTMENT FOR BUTTER, NONFAT DRY MILK, CHEDDAR CHEESE AND SKIM WHEY POWDER PLANTS BY VARIOUS POSSIBLE MANUFACTURING COST ALLOWANCES

Based on cost studies for calendar year 2004, released November 2005, revised January 2006

Manufacturing Cost Allowance ($/lb)	Return on Investment for this Allowance			
	Butter	Nonfat Dry Milk	Cheddar Cheese	Skim Whey Powder
$0.10	-29%			
$0.11	-20%			
$0.12	-10%			
$0.13	0%	-13%		
$0.14	9%	-5%		
$0.15	19%	3%		
$0.16	29%	11%	-7%	
$0.17	38%	19%	1%	
$0.18	48%	27%	9%	
$0.19	57%	35%	17%	
$0.20	67%	43%	25%	
$0.21	77%	51%	32%	
$0.22	86%	59%		
$0.23	96%	67%		
$0.24	106%	75%		-3%
$0.25	115%	83%		-2%
$0.26	125%	91%		-1%
$0.27	134%	99%		0%
$0.28	144%	107%		1%
$0.29	154%	115%		2%
$0.30	163%	123%		3%
$0.31	173%	131%		4%
$0.32	183%	139%		5%
$0.33	192%	147%		7%
$0.34	202%	155%		8%
$0.35	211%			
$0.36	221%			
$0.37	231%			
$0.38	240%			
$0.39	250%			

Appendix F

SUMMARY OF TESTIMONY AND POST HEARING BRIEFS

DAIRY INSTITUTE– Bill Schiek

- The Department is responsible for regulating the operating margins that dairy product manufacturers are allowed more than regulating the price level received by dairymen
- In order to ensure an adequate plant capacity for the state's milk supply, existing plants must be competitive and plant margins must be sufficient to attract new investment
- Reductions in cheesemaker margins that occurred after the 2003 hearing decision was implemented have played a major role in the lack of commitments to build new cheese plants since 1999
- The greatest risk in any minimum milk price regulation decision is setting prices too high, as setting prices too low allows market forces to correct by allowing commodity price to increases and through the development of incentive payments from processors to producers
- Attracting investment in cheese plants, or in other higher-valued uses, would be better policy for the state than encouraging greater capacity in butter-powder operations, given California's large share of the national NFDM and butter markets
- At the margin, producer pool prices would increase if new capacity were directed toward Class 4b. Therefore, the state should encourage cheese manufacturing capacity growth over butter-powder capacity growth
- Product yields should be established based on California milk of average, farm-level composition that has not been "incentivized" to alter its composition. In the case of cheese, average composition should include casein content for raw milk at average producer test. Average California finished product moisture should be used. Fortification should not be considered in determining product yields and fortification-related costs should be deleted from make allowances
- Changes to Class 4a pricing formulas should not disadvantage California's Class 2 and 3 manufacturers relative to those in nearby states
- The simple average monthly difference between California's weighted average cheese price and the CME price for 40-pound cheddar blocks during January 2004 through December 2005 should be used in lieu of a longer period that would reduce the variability from lags because costs of transporting product from California to the Midwest increases substantially in recent years
- A 12-month period would be too short for cheese since it would not provide enough observations to "average out" the impact of the lagged response of California cheese prices to CME movements
- Using a weighted average introduces bias into the estimator because there is no theoretical or practical reason why one month's observation of the price difference should be more heavily weighted than another in predicting the monthly relationship between the CME and California prices
- Dry whey should not be incorporated into the Class 4b formula because non-cream whey processing is undertaken primarily as a cost-minimization strategy rather than a profit-generating opportunity and because multiple products are manufactured from the whey stream and have their own unique market
- Because removing the dry whey factor would have a negative impact on current producer prices, the Institute recommends first increasing the make allowance for dry whey and

then removing dry whey from the formula when it begins to negatively impact producer prices
- The proposed snubber on dry whey over-values producer milk and violates the tenets of end product pricing in that all the costs of manufacturing be deducted from the product prices
- Using fortified vat yields transfers the cheesemaking value of the fortification ingredients and assumes that value is contained in typical milk
- At a minimum, if fortified vat yields were to be used in the formula, all costs associated with fortification ingredients, including all protein premiums should be included in the manufacturing allowance
- Because we do not have plant data on producer milk yields, using a theoretical cheese yield formula (VanSlyke) would be the best alternative.
- Today we have a milk supply that is more differentiated, and it is important that yield assumptions be representative of what can be achieved with typical producer milk
- Although an industry discussion on yields is welcomed by the Institute, it is not convinced it will be fruitful enough to resolve the issue of cheese yields.
- The Institute agrees with the Panel's previous findings on price floors and does not support their incorporation into the formulas.
- The Institute is philosophically opposed to the variable make allowances proposed by Land O' Lakes because it mutes the economic signals of the market place
- The Institute believes the Alliance proposal to index natural gas prices has some appeal but merits further study and suggests the Department convene a workshop to consider the idea. The Institute disagrees with Alliance's use of a 12-month weighted price difference in setting the f.o.b. adjuster levels.
- The Institute recommends rejecting the proposal from CDI.
- The Institute sees no valid economic justification for cost-of-production indexed variable make allowances proposed by CDC.
- The Institute finds the MPC concept of cheese marketing allowance and CCC sales credit has some merit, but finds the remainder of MPC's proposal problematic and urges its rejection.
- The Institute also urges for the rejection of Western United's proposal.

ALLIANCE - Jim Tillison

- The pricing systems needs to stay current by reflecting the volatility of energy costs, in particular natural gas costs - a key component of the cost of manufacturing
- The snubber should be reinstated because when the disposal of whey becomes a cost, the manufacturing allowance data reflects that fact
- The cost of retentate from the further whey processing should not be included in non-labor processing costs in the cheese make allowance because it is covered in the formula for converting liquid whey into dry whey
- There is little incentive for plants to move cheese to the CCC and flooring commodity values at support and butter and powder produced mainly by cooperatives to balance the milk supply with demand by moving butter and powder to the CCC. Flooring will allow the cost market balancing to be shared among all kinds of plants
- The vast majority of whey protein is going into higher valued whey protein concentrate. Rather than drop the other solids value from the Class 4b formula, the Alliance again encourages the Department to begin gathering manufacturing cost data from WPC

- The Department should come up with a weighted average price for cheese, however the concern is that when cheese plants are able to capture additional revenues through marketing, that gain becomes part of the price
- The Departments decision should not be based on encouraging or discouraging dairy farmers from producing milk because the market takes care of that through commodity prices which move up and down based on supply and demand

WESTERN UNITED DAIRYMEN – Mike Marsh and Tiffany LaMendola

- Implementing the Diary Institutes position would create an even greater disparity between California and Federal prices, thus violating the mandates of Section 62062 of the Food and Ag Code
- As processing plants have experienced increased energy, labor, and transportation costs, so too have producers. Producer margins have also been squeezed
- It is unlikely that adjustments sought to the minimum prices will provide incentives for new plant capacity in the state of California as the impediments to building plants in the state go beyond the regulated minimum prices
- Because processors are not required to avail themselves of the opportunity to sell to the government, the only means to reap the benefits of the safety net is in the pricing system
- Western United does not agree that that floors in California alone place the cost of a federal dairy price support program on California processors as price floors would have been triggered infrequently, NFDM does not fall below support because of sales to the CCC, implementing the floor may help encourage the streamlining of the CCC, and the increase in CME cheese price immediately following implementation of the floor proves the influence of California's milk pricing policies on the national market
- A fat recovery level of 92% would be in line with testimony submitted by Dr. David M. Barbano of Cornell University at the May 2000 federal order hearing and ranch-to-plant as well as in-plant losses are adequately accounted for through several means in the current pricing formulas
- In the event that cheese yields are determined from pre-fortified vats, Western United suggests removing the fortification costs from the make allowance
- Based on the data from Phillip Tong, Western United determined 38.09% as an appropriate moisture level to use in the Van Slyke formula.
- Whey is no longer a cost minimization strategy
- Just as Cheddar cheese, representing just 24 percent of California cheese production, is used as a surrogate in the pricing formula for cheese, and similarly NFDM used for powder, we can use skim whey powder as a surrogate for all other whey products
- Skim whey powder is the basic, lowest priced whey product derived from producers' milk used for cheesemaking, and thus plants are able and encouraged to produce higher-valued whey products
- Whey from Mozzarella plants is expected to have different manufacturing costs than those of whey produced from Cheddar cheese plants, and thus the use of the Department's cost studies, which include data from a Mozzarella plant, a Parmesan plant, and a Cheddar cheese plant, leads to serious consideration of the use of the cost figures released
- Additional data available from several alternative sources suggest a lower manufacturing cost for dry whey than the Department's weighted average costs
- The make allowance for whey, as a byproduct of cheese, should not carry milk and receiving costs as these costs are accurately reflected in the cheese manufacturing costs

- Only 79 percent of the skim whey powder processed in California is represented in the cost study vs. 99.9% for butter, 98.5% for Cheddar and Monterey cheese, and 99.17% for NFDM
- Western United board was concerned with the large change in ROI for the 2004 cost studies following the implementation of a new ROI factor. An increase of this magnitude merited more input from all parties involved
- The Western United board was also concerned about the increase in General and Administrative costs in the cheese cost studies as producers deal with the same costs on their own operations with no mechanism to finance them
- Western United does not support the CDC's proposal of a variable make allowance and elimination of f.o.b. adjusters given their negative impact on producers
- Western United supports CDI's proposal to floor commodity prices, but not changes to the make allowances
- Western United also supports the Alliance proposal to adopt price floors, but not changes to the make allowances
- Western United supports MPC's proposed implementation of a "snubber" on dry whey at $0.20 and the board found MPC's incorporation of WPC-34% intriguing, but the specific details need to be flushed out. A credit to the CCC for processors also has some merit, but is not needed given the recent streamlines implemented by the CCC
- Western United does not support Land O'Lakes proposal to change the dry whey manufacturing cost

CALIFORNIA DAIRIES INC. - Joe Heffington and Richard Cotta

- CDI dairy farmers are in the process of making a $125 million investment in a new plant which is not projected to be profitable, even at the make allowance levels being requested
- The negative impact of an increase in the Class 4b make allowance at levels proposed by the petitioner would be very damaging to the entire California dairy industry
- CDI believes that the implementation of a floor will send a market signal and encourage processors to sell to the CCC when prices fall to support price levels. CDI's estimated additional cost of selling nonfat powder to the CCC through DairyAmerica was $0.18 per pound
- When proprietary processors have been faced with selling to the CCC they have instead chosen to discount their sales price to match commercial competition, resulting in the CME price falling below the support purchase price level
- CDI supports cost justified changes to the make allowance based on the weighted average manufacturing cost data as published by CDFA
- CDI has and will continue to go to the market to recover costs through energy cost surcharges. However, these surcharges increase the milk price and manufacturers still absorb cost increases. Cost increases are real and the make allowance needs to be adjusted to recognize this
- Currently, the sales value of buttermilk powder is now approximately $0.15 to $.020 per pound below the value of non-fat powder, while in recent years the values were much closer, helping to recover the cost of the nonfat solids and butterfat in the buttermilk powder. This shortfall in sales revenue created by the lower buttermilk price should be considered in the Department's Hearing findings
- Forward pricing sales should not be included in CDFA's sales price audits because it is not reasonable for Dairymen to take the risk for forward priced sales.

- CDI proposed the f.o.b. adjusters be changed to the weighted average difference for the 12 months ended December 31, 2005
- To improve the data collection process and allow for the calculation and comparison of a weighted average sales price to the weighted average CME price, CDI suggests CDFA request the weekly manufacturers reports submitted to NASS detailing the bulk 25 kg salted butter and block cheddar cheese sales and tabulate the sales price results throughout the year. Using this data, the weighted average sales prices can be compared to the weighted average CME prices for the same time period and the inaccuracy caused by calendar month to the 26th of the prior month to the 25th of the current month can be eliminated
- Utilizing the concept of percentage of volume covered to set make allowances may be problematic as inefficient plants close and fewer are included in the cost study, making the eventual percentage covering only a percentage of even the most efficient operations
- An appropriate level of make allowance is required to encourage standby balancing capacity to stay available in California
- Investment in California's powder manufacturing should be encouraged to provide the capacity to process the solids that need to be exported to balance the State's milk supply. CDI also believes this is a large growth area available to the California dairy industry

CALIFORNIA DAIRY CAMPAIGN – Joe Augusto and Scott Magneson

- Producer prices have reached their lowest level in two years and at the same time producer input costs have continued to go up, so producers are unable to cover their cost of production
- Under the California pricing system California processors are able to sell dairy products below prevailing market prices, in effect lowering the CME price upon which producer prices are based
- California plants are continuously asking for more milk than the market is demanding
- Contrary to the Institute claims that prospects for new plant investment have "dimmed", significant expansion is occurring at plants in Hanford and Lemoore
- The current make allowance system overall sends a false signal to processors to continue production regardless of market demand and encourages processors to run as much raw milk through the plants as possible regardless of market conditions
- A milk pricing system that is balanced requires that dairy product prices, producers' cost of production, and plants' cost all be given consideration when determining the value of milk
- The current 4b formula should be modified to better reflect the market, as the formula is based on the price of cheddar cheese - one of the least profitable cheeses sold in the marketplace today. Producers should be able to reap the rewards of the higher valued mozzarella and high moisture cheese as processors have for some time now
- More must be done to address the concentration in the dairy sector that has allowed market manipulation by large processors to keep producer prices chronically low

MILK PRODUCERS COUNCIL – Geoffrey Vanden Huevel and William C. Van Dam

- Any discount CDFA gives to California cheese plants, could be matched by the unregulated Idaho competition

- The similar situation of the 1980's garnered significant producer support when the federal support price for milk was more than $12 per hundredweight. However, that support no longer exists with the support price down at $9.80 and increased costs of production for dairy producers. Nothing is certain about policy established through a process that lacks consensus
- MPC supports the status quo, however they have offered constructive alternatives for consideration in light of the fact that the hearing was called
- MPC supports a fair and sensible price for the whey factor that reflects a meaningful minimum value that plants can expect to recover from the marketplace
- The cost audits done by the Department for SWP in California should be abandon as they only capture a small amount of the whey solids available from cheese processors
- MPC suggests that the make allowance be determined by using Departmental data to asses the volume of SWP that could be made from cheese plants scaled against the actual cost study data from NFDM plants and adding 3 cents for additional costs associated with drying whey compared to skim milk
- The greater risk is in setting the make allowance for SWP too high, as this would encourage investment in SWP production, lead to a decrease in price of SWP, and discourage shifting out of SWP production to other products
- SWP continues to be the product upon which to base a formula to calculate a minimum whey value as it is the simplest and most complete recovery of whey in a marketable form
- MPC applied a more appropriate Correlation Coefficient, rather than an r-squared to determine a 87% correlation of SWP and WPC 34 prices
- A snubber should be included in the whey formula, as its exclusion will discourage innovation and given the low volume of whey being made into SWP, the market is subject to manipulation by processors of WPC
- To address the concerns of SWP production not being broadly representative of California whey usage and as an alternative to thus removing the factor all together, MPC suggests the inclusion of WPC 34 price with a manufacturing cost allowance that is calculated to make whey pricing "neutral" over the past 5 years
- Cheese is the only product for which there are production and packaging requirements for sales to the CCC substantially different from normal commercial sales, and cheese is the only commodity of which prices dropped substantially below the support price. Thus, MPC argues for the use of a floor on the cheddar cheese price in combination with a transaction credit to processors from selling to the CCC. The CCC transaction allowance would be the difference between 5 cents and the current California price Adjuster
- The MPC proposal, to reduce 4b milk cost by 2.5% of the difference between the SPP for cheese and the CME price, avoids the pitfalls of indexing while giving a significant boost to cheese plant profits in times of higher prices
- After seeing the newly released audited data for the difference between the CME and California sales prices, MPC is content to watch the market to see that the price differences continue to narrow as expected, rather than apply 50% of the difference as proposed by MPC
- MPC believes the current cheese yield of 10.2 is appropriate and this is corroborated by data from Hilmar cheese plant published in an article in Hoard's Dairymen
- Because rotating the whey cream back into later vats of cheese is far more profitable recovery than making off-grade butter, it no longer makes sense to apply the 1- cent per pound deduction for whey cream and instead, the whey cream should be valued at the butterfat values established in 300 (D) (1)
- MPC has no objection to changes in the existing make allowances provided they are based on actual cost increases. Because the Alliance indexing proposal is a significant

deviation from existing procedure and would be based on factors other than real costs, MPC does not support the Alliance indexing proposal

LAND O' LAKES – Tom Wegner and Jim Grueble

- Although the current Class 4b formula reflects whey, a much larger proportion of the whey stream is converted into whey protein concentrates The inclusion of whey formula and not whey protein concentrates has become more problematic for processors as the whey market has strengthened while whey protein concentrate prices have weakened
- The LOL proposal for a variable make allowance in the whey factor would allow both producers and cheese plants to share in the gain when the whey market is higher than the make allowance and share in the losses when prices are below the make allowance
- If the whey make allowance is not adjusted to reflect the weighted average cost for whey, then LOL recommends complete elimination of the factor from the formula
- LOL believes the state's plant capacity is being pressured and has heard reports of distress milk being dumped because of plants unable to process the milk. There have been several plant closing within the last few years, exacerbating the problem, and LOL feels that without a significant adjustment in them make allowances, including whey, it would not be surprising to observe further decreases in plant capacity in California
- Producers who are independent or belong to a cooperative not investing in cheese operations have benefited at the expense of LOL's member who made a significant investment in a new cheese plant for which they are not earning a reasonable return on their invested capital, thus resulting in an equity issue. When LOL chose to build a cheese plant, the whey factor was not in the pricing formula and therefore this risk could not be calculated
- LOL performs an important balancing function in the state by processing not only their members' milk, but also milk from non-member producers
- The returns on investment for LOL butter and powder operations are clearly much higher than for cheese operations, which raises significant questions about the direction of the future investments in new plant operations in California. LOL urges a balanced approach so that returns on investment for cheese and for butter-powder operations are very similar
- Cheese operations in Federal orders are allowed the option to de-pool while California cheese plants are not afforded that option. Those handlers whose milk is de-pooled do not have to share the Class III revenues with other producers. California manufacturing plants also face different and sometimes higher level operating costs than costs faced by plants in other states

HILMAR CHEESE COMPANY - Patty Stroup

- Hilmar supports Dairy Institute's request for changes based on two factors – the current 4b price is too high and the regulated pricing system in California suppresses product innovation and handicaps the industry by lack of flexibility
- A snubber on a whey make allowance overvalues the whey proteins in milk and necessitates that the revenues in cheese operations "make up the difference"
- A floor on commodities in regulated California prices puts the entire burden of supporting milk prices above the federal price support level on California processors. California processors must also bear the impact on commodity prices resulting from decisions, activities and conditions outside of California and, therefore, beyond our control

- Whey products have completely different end-uses and, at some levels, are not priced off of any published market. More than a third of whey protein concentrate is exported and faces international competition not reliant on a U.S. published price and whey products' biggest competition is not from other dairy products, but from soy proteins not subject to regulated prices
- Because whey operations by nature are not flexible enough to switch drastically between products and because they are so capital intensive, investment into one form of whey can end up being a liability
- Hilmar is paying for milk based on the dry whey market when they do not make or sell dry whey, but make whey protein concentrate and lactose
- Removing the whey factor would bring the regulated price back to a minimum, with whey proceeds distributed to dairymen outside of the regulated pool price
- It is in the best interest of milk producers to have diverse forms of whey manufactured in California as it results in a stronger manufacturing industry and more competition for milk
- Variable manufacturing allowances that share the gain and share the pain will distribute too much money to producers when milk production is high and not enough money to producers when milk production is low
- The margins for cheese plants are not high enough to justify building cheese facilities and the demand for Classes 1, 2 and 3 is not increasing enough to stimulate processing growth in those sectors, so the new plants to come online will be plants manufacturing Class 4a products
- High regulated prices that incorporate proceeds from all dairy products, even byproducts like whey, do nothing to encourage innovation and instead take money from producers who have invested in innovation and consumer demand and give it to those who haven't

KRAFT FOODS – Michael McCully

- At last year's hearing it was mentioned that milk supplies would continue and producers and cooperative would be forced to ship milk outside the state to find manufacturing capacity. This year milk has been shipped out of California for processing as well as dumped because of limited manufacturing capacity
- NMPF believes in a higher make allowances, even though it means lower producer prices in the short-term, in the long run both the manufacturing facilities and the producers will ultimately benefit
- DFA's loss of approximately $35 million at Golden Cheese in 2005 has management looking for options to mitigate their losses
- April 2006, Kraft announced the closure of its Visalia plant and the plan to have their Tulare plant absorb some of the production, operation, and manufacturing equipment
- Kraft will continue to evaluate the regulatory and political environment in determining their future investment decisions. If California is perceived as an unfriendly environment for processors, investment money will not be forthcoming
- California's competitive position in the US dairy industry is negatively impacted by the fact that Manufacturing costs are higher than other parts of the county. Kraft's two plant average comparison shows electricity costs are 100% higher in California while natural gas is 5% higher
- Minimum regulated milk prices will enable California plants to be competitive with plants in other parts of the country

- In the last year, increased fuel costs have increased transportation costs from 6 cents/lb to around 9 cents/lb. This puts California products at a disadvantage to products from other areas
- Kraft concurs with last year's Hearing Panel decision to eliminate price floors from the formula
- Kraft feels the whey component and any whey price snubbers should be eliminated from the 4b formula
- Unlike cheese, butter and NFDM, there is not one standard whey product that is appropriate to use in pricing formulas. Kraft believes the Hearing Panel's decision, last year, to remove the whey factor from the 4b formula was correct and should be implemented this year
- Kraft does not allow the addition of whey cream in their cheddar cheese or parmesan cheese production process. The whey cream is sold and not used internally

- **CONTINENTAL DAIRY PRODUCTS INC. / SELECT MILK PRODUCERS INC. – Benjamin Yale**

- Market forces will offset any purported increase in the spread between minimum prices for manufacturing milk in California and prices in Federal Milk Marketing Order regions
- Opposed to the Dairy Institutes petition, with or without whey, but are not directly supporting other proposals
- A reduction in the 4a price for milk in California will cause a response by the cheese making regions to reduce prices throughout the nation
- California weekly plant prices are a major part of setting FMMO prices for the USDA. The FMMO price for milk responds directly to the California product price
- National, global, market forces will adjust to erase any market advantage the California plants once had by regulating under priced milk
- Non-dairy regulatory, tax and other issues create significant economic disincentives for non Californians to consider building a dairy in this state
- The announcement of Hilmar building a large cheese plant in West Texas and California producers building new dairies in other states is indicative of California's unfavorable economic environment to new construction
- The Department cannot rely upon the prospect of the USDA using its regulatory power to lower the spread between Class III and 4a
- Producers face the same economic costs as plants in addition to newer and higher costs of environmental stewardship. However the producers can only recover these costs from higher, not lower, prices from the plants
- A lower 4a price will not increase the desired capacity as other issues facing California businesses will discourage the expansion or construction of new facilities
- Reducing producer milk prices will not address the real problem which is more competitive transportation costs for plants located further East nearer the market
- Because the value of milk may exceed the value at an individual plant, lowering the milk price will reduce the overall value of milk
- There is a cost to recycling whey but there is also a greater return for doing so. Therefore it should be measured and returned to producers in the formula
- Fortification is largely used to maximize the butterfat, making the milk more valuable and therefore should be included in the formula. It is unrealistic to use end product pricing to reflect the value but ignore the key profit centers
- Select and Continental request not to reduce producer prices. They believe the national market will adjust downward to match any changes, reducing producer prices elsewhere

SAPUTO CHEESE USA INC. – Greg Dryer

- Testified in support of Dairy Institute's proposal
- Whey processing facilities are highly specialized with little flexibility for plants to switch production from one type of product to another
- In California, Saputo produces WPC of varying protein levels and participates in a joint venture in production of whey protein isolates. Since 2004, they have been unable to attain anywhere near the profits implied for whey byproducts in the California 4b formula
- Saputo believes if the 4b formula employed an up-to-date and adequate make allowance, then the whey factor in the price might make sense. But, extended periods of unusually high or low prices, like the recent change in the price of dry whey, have the potential of placing producers or processors in jeopardy, and therefore Saputo supports the elimination of the whey factor from the 4b formula
- The benefit of the California system is the responsiveness of the system to rapid change as compared to the slower-moving federal system. However, investment decisions utilize a longer time horizon and thus changes made to the system subsequent to major investments by processors can dramatically affect the longevity of an investment
- Higher costs for dairy quality process space, tax charges, construction permitting, rising transportation costs, labor rates, and electricity costs in California versus other regions of the nation should also be considered

CRYSTAL CREAM & BUTTER COMPANY – Sharon Hale

- Crystal ceased NFDM production in 2002 and earlier this year stopped producing butter. Since then crystal has kept their independent supply at a point where minimum needs are covered and additional needs are met with supplemental purchases on an as needed basis. However, since February there were concerns about excess milk and in April the lack of available processing capacity of large manufacturers meant they were forced to move some milk over 200 miles. By early May, Crystal made the decision to hold producers to contract and share the burden of excess milk
- Crystal supports the status quo relative to the price relationships between the Class 4a and Class 2 and 3 prices

LEPRINO FOODS COMPANY –Sue Taylor

- Testifying in support of the Dairy Institute proposal and in opposition to proposals put forth by Alliance, WUD, MPC, and CDC
- Specific issues focused on include: Need for plant capacity, the whey factor, yields, and price snubbers.
- The current milk price formulas as a result of the 2003 decision and the business environment in California have caused Leprino to explore expanding opportunities outside of California rather than expand the Lemoore West facility in California.
- Capacity constraints in the trucking industry due to driver shortages and DOT hours of service regulations implemented a few years ago and increased fuel costs have resulted in escalating transportation costs. Our experience is that freight rates outbound from California are increasing at roughly double the rate of increase we are seeing outside California.

- The current construction at the Lemoore West facility referenced by the CDC witness at this hearing will increase our line flexibility and will not result in expanded milk throughput capacity.
- The milk price factor attributable to the sweet whey value has outstripped the returns from the WPC/lactose complex numerous months over the last year and the whey markets may take more time than expected to equilibrate because of different whey market niches, the inability of plants to easily flip between producing WPC-35 and WPC-80, and the influence of international supply and demand conditions.
- There is not a common whey product produced within California and the nature of supply and demand in the various whey markets, both domestically and abroad, make it nearly impossible to identify a whey product that will accurately reflect the returns generated by the whey complex.
- The VanSlyke theoretical yield formula remains the only objective way to determine the cheddar yield in the absence of actual data related to yields from unfortified, unincented milk. In addition, Dr. Tong's data in the VanSlyke formula would fail to capture ranch-plant losses because of missing ranch-level data.
- Implementing a snubber for whey allows producers to collect the beneficial revenues available when prices are high, and processors to suffer the losses when market value exceeds the manufacturing costs. Those who receive the benefits should also incur the losses.
- Commodity floor prices require California cheese makers to guarantee a market value for cheese that is not guaranteed under the federal program. In the end, as in-state plants become unwilling to accept producers milk and milk moves of state to find capacity, it may become more costly to producers than it would have been had the commodity prices been allowed to fall below support.

FARMDALE CREAMERY INC. – Scott Hofferber and Mike Shotts

- Farmdale supports the Department's audited cost data which indicates that the make allowances should be set at the cost-justified levels proposed by the Institute
- A minimum pricing system should be minimal so as to allow free-market forces to work more freely, thus allowing the risk of investment to be appropriately shared between processors and producers, the possibility of an attractive ROI on additional processing capacity, and the ability of the market to correct during conditions of under/over-supply
- Farmdale disposes of the waste whey stream by converting it into a dried product for animal feed. Farmdale looked at several alternative options for processing whey including processing liquid and powder WPC at various protein concentrations, liquid and powder permeate, and partially processing the whey stream into a 65%-liquid to be dried at another facility. but could not find a cost-effective alternative
- Floors should remain out of the formula so that we maintain an environment of shared risk between producers and processors
- Net producers prices have nothing to do with what it costs plants to convert milk into cheese, and thus current producers prices are irrelevant to the make allowance decision
- Farmdale does in fact convert their whey cream into Grade B butter
- A whey factor should not be included in the formula as it complicated matters and has not proven to be the benefit producers had originally thought it would be

JOHN ROSSI HAY COMPANY, INC. and AMPSI – John Rossi

- States that the timing of this proposed increase in make allowance couldn't be worse
- Over production is not the fault of the dairymen
- Hay costs are very high
- If increase the make allowance, then need to increase the support price to $12.50/cwt.

CALIFORNIA DAIRY WOMEN ASSOCIATION – Linda Lopes

- CDWA represents 180 dairy producers from Sonoma to Tehachapi
- Opposed to increase in make allowance as reduction in prices to producers would be devastating
- Every 500 cow dairy is losing approx. $17,000 per month
- According to Genske Muldur & Co. the average dairy will lose about $1.62 per cwt. in 2006
- Producers are experiencing the same higher energy costs as processors
- Support Milk Producers Council and Western United Dairymen proposals
- Support Floors being reinstated

CARINALLI DAIRY – Domenic Carinalli

- Do not support removing dry whey from formula
- Proposed decrease of $0.51 per cwt would be devastating to dairy industry

BLUE RIBBON CHEESE CO. – Craig M. Rasmussen

- Support Dairy Institute changes to the Class 4b formula
- Blue Ribbon Cheese is beginning construction of Cheddar and mozzarella cheese manufacturing plant and whey derived products – handle 6.8 million pounds of milk per day
- We have had to consider alternative state sites for our plant because of increased energy, labor, workman's compensation, and transportation costs in California
- State needs additional plant capacity

MULAS DAIRY COMPANY, SONOMA – Vickie Mulas

- Milk prices are very low – price reduction would add to burden
- Production costs are high with the higher energy and labor costs – and proposed environmental regulations
- Producers do not have an opportunity to pass along costs to anyone
- Surcharges have been in effect for producers for quite some time
- Suggest regulation the price processors can charge consumers for products based on what is paid producers
- Bad timing for decrease in producer prices

BELINDA SILVA

- Cost of operation has increased to all industries, including dairying
- Many of the venders to the Silva dairy have passed on their added fuel, energy, and workman's comp to the dairies including the waterman, the dead stock pickup man, the tire service man, the waste water service, and Hilmar cheese

CARL VAN VLIET

- Opposes the Institute's petition and other petitions put forward by the processors and any increase in make allowances
- More dairymen would have been at the hearing had it not been scheduled on June 1 which is payday for workers
- Now is not the time to lower producer prices
- Urge's the Department to adopt CDC's petition to floor the commodity purchase prices
- Retail prices in stores are not reflective of the supply and demand governed by the market and therefore consumers are not given the opportunity to buy more to create a greater demand
- To accept big increases in production without increases in market will lead to a glut of milk and drive milk prices to drop
- Supports a variable make allowance which would give processors the incentive to keep the supply and demand healthy

JERRY CORDA

- Oppose the Institute's proposal
- It's gotten harder to be able to survive enough to pass the tradition of dairying on to the next generation

MONIQUE MORETTI

- The Institute's proposal couldn't come at a worse time as we are struggling to make ends meat and can't pass on our costs.
- The impact the Institute's proposal can have on dairy farmers could be dramatic and should be taken into consideration

CENTER ON RACE, POVERTY & THE ENVIRONMENT – Avinash Kar

- The changes to the Milk Plans create incentives for building and operating more milk processing plants and possibly more dairies with environmental impacts, especially in Central Valley
- Department should not approve Milk Plans until ensures measures in place to address potential environmental impacts
- Impacts likely to be felt in Central Valley

- Increase make allowance will reduce business costs, create incentives to invest in construction of new milk processing plants'
- Milk production growth will generate environmental impacts through expansion of new construction of dairies
- Dairies are largest smog-forming volatile organic compounds in San Joaquin Valley, out-polluting cars, oil and gas production, and pesticides
- Effluent discharges from facilities and with whey from cheese-making – results in greater environmental impacts

BACCHETTI & SILVA DAIRY – Ann Bacchetti-Silva

- Proposed changes to make allowance would decrease producer prices
- Producers are facing economic and regulatory pressures now
- Producers have experiences the same energy and labor costs as processors
- Our hauling costs are also up

CIRCLE H DAIRY RANCH, INC. – Margo Souza

- Changes proposed will drastically decrease minimum pool price – will impact my dairy operation
- Oppose the Institute proposal

DAVID INMAN

- Department decision always help processors
- Supports floors on Class 4a and 4b
- Department should stop illegal use of milk protein concentrate in standardized and non-standardized food products – should enforce fluid standards
- Producers are experiencing high energy and transportation costs

MARCHY DAIRY – Gary Marchy

- Our milk prices have dropped below our cost of production
- Rising costs of energy, labor, feed, fuel and transportation and proposed environmental regulations have been hard to absorb
- Overbase price reduction as proposed would be detrimental to dairy industry
- No way to pass on our increased costs

CASE VAN STEYN

- Supports the testimony of Western United Dairymen
- Concerned about changes to a system that has worked for many years and has provided security to dairy farmers
- Commitments to invest reflect a long term outlook and it's not a price cycle thing

- Making significant changes to the formula as suggested by the Institute is going to hurt the California dairy industry farther than we can anticipate today and will have longer term effects.
- Processors are on a level playing field and have an equal advantage in competition with each other

RAY SOUZA

- Supports the testimony of Western United Dairymen
- Well aware of the serious problems that limited plant capacity can bring to California
- Restricting plant capacity will not raise prices to producers
- History doesn't tell us that California is not a friendly climate for cheese producers with an expanded cheese market and an expanding ability to produce cheese
- Producers are far below cost of production and lower milk prices would be disastrous
- The current increases in expenses for dairy farmers are at an all-time high with no sign of it getting any better
- The industry will slow down milk production as individual producers go out of business, but that takes time
- It's not clear that reducing make allowances or devaluing producer commodity prices value in their milk will solve the issue of plant capacity
- We must be careful not to undervalue the commodities in our milk strictly for the purpose of increasing plant capacity
- The issue of plant capacity should be addressed through a good industry-wide strategy that includes producers and processors to get a real solution rather than through a make allowance formula change or devaluation of a particular commodity

ALBERT NUNES

- CPA and partner in the firm Genske, Mulder and Company
- According to the cost studies, costs to dairymen increased by 61 cents per hundredweight between 2004 and 2005
- An average dairy is going to lose 2.48 cents per hundredweight or $507 per cow given the current $10.40 milk price
- Every 1 point increase in interest rate is going to add 13 cents per hundredweight to the dairyman's cost, so you've got at least 26 cents more coming in to '06
- Feed costs look to be about 10 to 15 cents higher in '06 then 2005
- The average dairyman is probably carrying $500 a cow debt and most banks will loan no more than $900 a cow
- Some dairymen are getting bigger just to compete and spread their fixed costs over more cows
- Land for dairying in California is at least 2 to 4 times more expensive than almost anywhere else in the county

POST HEARING BRIEFS

LEPRINO FOODS

- Clarification of protein level descriptions of WPC products:

- WPC-34 describes protein content on finished product basis whereas WPC-35 describes protein content on a dry matter basis (The same description applies to WPC-78 and WPC-80 respectively)

CALIFORNIA DAIRY CAMPAIGN – Joe Augusto

- Support price floor at federal purchase support price – attached signatures
- Ongoing plant expansions indicate current make allowance sufficient
- Plant expansions: Marquez Brothers expanding to yogurt; Leprino (Lemoore) expanding for additional cheesemaking; CDI (Visalia) adding evaporator/dryer tower, butter churn and packaging operation.
- CDC favors varied make allowance to allow for market conditions

ALLIANCE OF WESTERN MILK PRODUCERS – Jim Tillison

- Supports natural gas price adjuster – most of plant energy needs are either natural gas or water power (don't need electricity adjuster)
- Do not need to complete a study to implement price adjuster concept
- Cheese yield should remain at 10.2
- Costs of processing dry whey in California dry whey plants far exceed what one would consider the industry norm. Dr. Charles Ling presented data at January federal hearing on make allowances from larger sampling than CDFA 3 whey plants – it was less than half of what CDFA claims
- West Farm Foods and Sue Taylor (Leprino) testified on increased cost of processing whey vs. skim milk – they want an increase in cost factory for whey
- Do not believe we should use whey drying costs of California – they are not representative of U.S.
- Vast majority of whey proteins are going into WPC products and not dry whey
- Whey should not have a negative effect on 4b price
- Do not recommend dropping whey factor in formula – but snub at 0.2742
- CDFA should complete a study on what whey product is most commonly produced, what does it cost to produce
- Any and all costs associated with whey processing should be removed from cheese manufacturing cost study data
- The cost of disposing leftover liquids from processing should not be included in non-labor processing costs in cheese cost study
- Support federal purchase price flooring
- CDFA should require California Cheddar and butter plants to submit weekly reports that they now give to NASS
- CDFA needs to recognize the fact that cost to produce milk has gone up as well as cost of manufacturing products
- Removing dry whey factor from formulas would impact producer prices in the long-term
- Cheese plant closures are not attributed to cost of making cheese

MILK PRODUCERS COUNCIL – William Van Dam

- In response to Panel question: Used 13% protein in calculating value of protein in skim whey powder
- Non Cheddar cheese production is market driven – no matter the price levels
- Balancing of milk supplies is being done by nonfat powder plants – if done by cheese it is the Cheddar plants doing the balancing
- Believe that Cheddar volumes produced in California affect CME prices
- Do not believe milk has been dumped recently
- Closing of plants is not attributed to 4b prices
- Some plants closed because they are no longer located where success is possible
- So not support either of the indexing proposals
- Cheese plants have a done a good job of marketing whey products – believe whey prices will go up
- Object to chart as Attachment A to Land O'Lakes testimony
- Object to chart as Appendix B in Hilmar Cheese testimony – we have attached a chart that uses better representation of data including whey

CALIFORNIA DAIRIES, INC. – Joe Heffington/Richard Cotta

- Experience large fluctuations in volumes through butter and powder plants on daily basis because of balancing function plants provide on milk supply
- Powder will account for 60% of U.S. dairy exports – need to invest in this market
- Submitted natural gas, electricity, and butter and powder rates showing energy rates are up significantly
- Dispute CDFA 2004 butter exhibit
- Concerned about freight rates to move butter outside California
- Weighted average calculations are needed for butter and cheese sales data
- CDFA needs to use the NASS reports submitted by plants each week
- In agreement with the process and outcome of manufactured cost studies
- Need to increase manufacturing

WESTERN UNITED DAIRYMEN – Mike Marsh

- Attached requested USDA press release on changes to the CCC purchases
- Support reimplementation of support price floors
- Object to updated cost studies and their use in the hearing process
- Object to lack of notification to producers of change in ROI factor in cost studies
- Whey should not be excluded from formulas
- Dropping whey would be eliminating a valued component
- WPC 34% protein prices have exceeded SWP 13% except the current year to date – this is a recent statistic – not a trend –Institute used a very short time period to display their data – not realistic
- Claims made by Center on Race, Poverty and Environment were unfounded and WUD disagrees with their logic
- A reduction in class prices to provide incentives for plant capacity would mean the Department is setting policy – something the dairy stakeholders should be doing

GREENBERG GLUSKER – David Cranston

- Voiced concern over Center for Race, Poverty and Environment contentions
- Amendments to the pricing formulas will not create a need for new processing facilities, or new dairies

DAIRY INSTITUTE – Bill Schiek

- Do not agree with Center for Race, Poverty and Environment contentions
- No guarantee that amendments to Plans will or will not create an environment where investment in milk processing plants or dairy farms will happen
- The r-square is the more appropriate statistics to use in ascertaining whether or not you can use dry whey prices to estimate changes in revenues by manufacturers of WPC
- Diverging whey markets are more likely to occur in the future than they have in the past
- Reinstating the support price floor will be ineffective in increasing producer prices
- The use of support floors does not prevent cheddar market from going below support floor price
- The tightening of cheese supplies, not the price floors, led to the increase in Cheddar market prices experienced in April 2003

LAND O'LAKES – Tom Wegner

- Supports increasing the whey make allowance to CDFA cost study level
- Supports increasing make allowances to level of CDFA audited data, including energy and labor updates
- Supports using simple average of the CME prices and simple average audited sales information for butter and cheese
- Recommend no change in make allowance for butter
- Agree with $0.2742 whey make allowance
- Noted that new Land O'Lakes facility that makes cheese other than Cheddar and other plants with similar products are not included in cost studies – they have cost factors unique to their operations not covered in cost studies
- Currently handle 1.5 million pounds of milk per day for non-members of Tulare plant – as milk from producer members increases, will no longer accept non-member milk
- Returns of investment for Tulare plant has been negative
- Tulare and Orland cheese operations profitability largely depends on cheese make allowance and whey formula

HILMAR CHEESE – Renee Raposo

- Attached notes concerning plant capacity issues – most notes relate to asking if they can take on extra milk
- Hilmar's projected cost of processing WPC-34 is much higher than the 26 cents suggested by an alternative proposal. Cannot share exact amount, but is approx. double of that suggested

CALIFORNIA DAIRY WOMEN ASSOCIATION – Linda Lopes

- Opposed to any proposal that would reduce the prices
- Make allowance increases and formula adjustments should not be used to increase plant capacity
- Support flooring the commodity prices
- Support snubbing the whey at the make allowance level so it cannot be negative

KRAFT – Mike McCully

- Reiterate that the whey factor was not addressed in federal order hearing
- According to suppliers and industry participants he spoke with – the shortage of trucks to haul milk from the farm combined with the lack of manufacturing capacity resulted in milk being disposed of on the farm – do not have exact data
- Kraft specifications do not allow any whey cream in the Cheddar cheese we purchase in California – We also do not add any whey cream to our Parmesan cheese production at Tulare plant
- 41 new expansion projects in place – 3 of which are in California
- Noted that farmer co-op members are realizing losses through their cooperative's losses in plant operations

JOHN ROSSI HAY CO. – John Rossi

- Not in favor of decreasing producer prices
- Should impose fine to processors until dairymen receives average cost of production

GENSKE, MULDER & CO., LLP – Albert Nunes

- Submitted Average Income and Expenses spreadsheets of their dairy clients as backup to their testimony