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June 8, 2006

David K. Ikari, Chief
Dairy Marketing Branch
California Department of Food and Agriculture
1220 N Street
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Re: Post-Hearing Brief for the June 1, 2006 Class 2, 3, 4a & 4b Hearing

Dear Mr. Ikari:

We thank you for the opportunity to file this post-hearing brief. There are a few items that we would like to address.

Streamlines to the Commodity Credit Corporation (CCC) Purchase Process

At the request of the Hearing Panel we have attached a USDA press release that details changes to the CCC purchase process. According to the press release, "USDA's Farm Service Agency (FSA) held meetings with dairy industry associations, representatives, trade groups and government agencies to obtain input on this new contract and related procedures. As a result, CCC has been able to streamline purchasing specifications and develop requirements that more closely adhere to commercial practices."

We are hopeful that the new CCC procedures will result in decreased costs associated with selling butter, nonfat dry milk (NFDM) and cheese to the government, thereby encouraging processors to actually sell to the CCC during times of depressed 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. Reimplementation of floors at the CCC purchase prices, combined with the CCC streamlines, would help provide incentives to processors to sell to the government. This will insure that the price support program put in place by Congress actually achieves the goal of providing a safety net for producers.

Butter, Powder and Cheese Manufacturing Cost Allowances

We stress, once again, that manufacturing cost allowances must be set at levels that are fair and reasonable to processors as well as producers. The Department has adhered to a historical policy of establishing manufacturing cost allowances that are consistent in volume coverage among butter, NFDM and Cheddar cheese. According to the 2004 cost studies, the current allowances covered 75% of the butter, 63% of the nonfat dry milk and 62% of the Cheddar cheese. Further review of the data sheds some additional insight. For butter, the 75% processed at a cost less than the make allowance was manufactured at a weighted average cost of $0.1230 per pound or 3.3 cents below the current make allowance. For NFDM, the 63% processed at a cost less than the make allowance was manufactured at a weighted average cost of $0.1373 per pound or 1.5 cents below the current make allowance. For cheese, nearly 77% was manufactured at a weighted average cost of $0.1710 per pound – exactly at the level of the current make allowance. The coverage is consistent, perhaps even exceeding in some areas, with the targeted coverage detailed in the Panel report from the last hearing (65% of butter, 67% of nonfat dry milk and 79% of Cheddar cheese).

We submit that the law requires that make allowances must be developed in consideration of the actual annual manufacturing cost studies prepared and released by the Department, and not upon partial and incomplete data based on estimates contained in so-called "updated" cost data or "estimated impact analyses." This view strictly conforms to the recommendations of the Department's own expert consultant regarding the impropriety of publishing or using such "data" (CPS Cost Study Consulting Report attached). Accordingly, we once again object to the inclusion in the record of the "updated" cost data or "estimated impact analyses." For the purpose of this hearing, only the 2004 actual cost studies should be used. Any increased costs or changes in volumes that may be experienced in 2005 will be reflected in the 2005 cost studies and appropriately considered, if necessary, at that time. Since these estimates were nonetheless included in the record over our objections, we submit that any use of or reliance upon such estimates by the Secretary in making his determinations would not only impair the Secretary's independence, but would also be completely arbitrary and capricious, and that any findings based on, or relying in whole or in part upon such estimates would be totally lacking in properly admissible evidentiary support.

Finally, we again express our concern with the change in the Return on Investment (ROI) factor in the cost studies. While our board of directors is not opposed to a change in the calculation (as the current index may be more appropriate), they are concerned with the lack of notification to producer organizations. Though it may not be the case in every year to follow, the change in the ROI calculation did result in a large increase in the category for the 2004 cost studies. This increase merited more input from all parties involved. Second, our board was very concerned over large General and Administrative costs in the cheese cost studies. We are not certain that producers should be required to cover costs such as those that were included as some producers are dealing with these kinds of costs on their own operations with no mechanism to finance them. We simply ask the Department to consider this when they consider proposals for increased cheese make allowances.

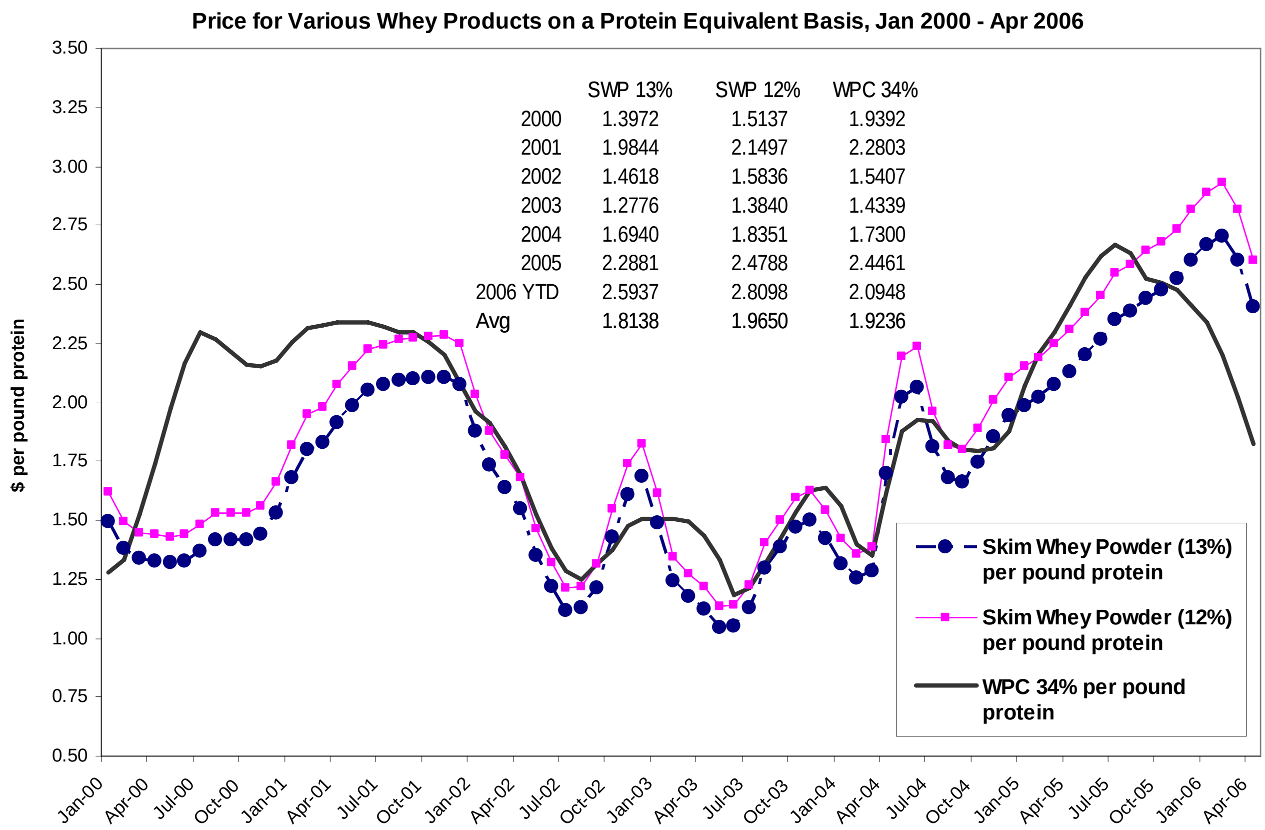
Dry Whey Component and Dry Whey Manufacturing Cost Allowance

Since California has become a dominant player in the market for whey products, it makes little sense for whey to be excluded from the California pricing scheme (as proposed by the petitioner). We have clearly outlined the value associated with whey products in our testimony and provided evidence as to setting the appropriate components in the formula.

A plea by several manufacturers to eliminate the dry whey component in the Class 4b pricing formula seems contrary to the concept of pooling. Testimony provided at the hearing suggest that the classified pricing formulas should result in *minimum* prices paid to producers and that competition will result in additional incentives to be paid to producers in other forms such as premiums. It is quite obvious, and has been demonstrated numerous times, that premiums are completely discretionary on the part of processors. The only price that producers are guaranteed to receive for their milk is through the regulated minimum pricing formulas. To that point, it is vital that the formulas be set appropriately to derive a value for the producer's raw milk. Eliminating a valued component, such as dry whey, and assuming plants will pay similar premiums in its absence in the formulas, is speculative at best and unsupported by the facts. To support pooling is to support the pooling of all components in each class of milk.

In regard to setting the appropriate components within the dry whey formula, we would like to expand on two particular points raised in our testimony.

First, in our testimony we compared skim whey prices to whey protein concentrate 34% prices for the period January 2000 through April 2006 as released by the Department. However, a comparison was provided by the petitioner and others that compared prices for various whey products on a protein equivalent basis. While we can not testify to whether or not this is the more appropriate comparison (i.e. protein equivalent or total per pound), we would like to point out the rather short time series (January 2005 through May 2006) that was supplied by the petitioner. A review of the period January 2000-April 2006 indicates a rather recent inversion of the skim whey powder (SWP) and whey protein concentrate 34% (WPC 34%) prices. It can be assumed that the markets will return to their normal trend of the higher protein whey products selling for prices exceeding those of SWP. We have also included a comparison in the chart below of SWP at both 12% protein (as used by the Dairy Institute) and at 13% protein which has been used by the Department in their analysis. Obviously, assuming a lower protein percentage will result in larger per pound of protein prices. In looking at yearly averages, WPC 34% per pound of protein prices have exceeded those of SWP 13% each year except for the current year to date. Again, the inversion is a recent phenomenon, not the trend.



A question was asked by the Hearing Panel about the appropriateness of comparing the dry whey plants to plants in the 2004 CDFA nonfat dry milk cost study as suggested in our testimony. We suggested that 2.50 cents could be added to the “medium cost” category in the CDFA nonfat dry milk cost study figures to derive an appropriate manufacturing cost allowance for dry whey. This suggested method was based on ample expert testimony supplied at the recent federal order manufacturing cost allowance hearing and is outlined in our written testimony. Concern was raised over the use of the NFDM plants in the medium cost category with an average volume of 59.6 million pounds when the dry whey facilities averaged volumes of 31.1 million pounds. We would like to reaffirm our position that it would be appropriate for the Department (who is privy to proprietary data) to choose the NFDM plants of similar size for use as a comparison. We do feel strongly that it would be inappropriate to use the plants in the "high cost" category who average a volume only 12.9 million pounds. These plants represent only 5.2% of the total NFDM product in the cost studies and are clearly balancing plants that operate on a limited basis. The lack of economies of scale is evident in the extremely high per unit cost associated with these plants.

Plant Capacity

Western United Dairymen understands clearly the economics and decision making that drives plant and dairy construction. We have testified to those reasons within our testimony at this hearing. Therefore, we feel it is important to assert that the claims made by the Center on Race, Poverty & the Environment (CRPE) in their letter dated May 24, 2006, and inserted into the hearing record are spurious at best.

CRPE claims, in part, that a processing plant's decision to construct a new plant or to expand an existing facility will encourage dairy construction. This claim is absurd and turns economic theory on its head. CRPE further claims that, based on this elementary misunderstanding about economics, CEQA review is triggered.

New dairy processing plant construction or expansion in California undergoes exhaustive CEQA review. Likewise, dairy construction or expansion may, in many instances, trigger CEQA. Amendments to the Stabilization and Marketing Plans by the Secretary do not. CRPE is in error and their claim is irresponsible. CRPE's claim must be rejected on its face due to the discussion above.

The broader issue of California's plant capacity was a primary concern expressed by processors at the hearing. We too, share this concern and are willing to work as an industry to address the issue. As noted in our testimony, we invited the Dairy Institute of California to co-host a public dialogue with dairy producers, dairy processors and dairy cooperatives with the purpose of discussing issues such as producer viability, plant capacity and incentives for plant construction, pooling and pricing and how best to meet shared environmental and energy challenges. For your reference, we have attached a copy of our invitation.

We understand Dr. Schiek's concern over the difficulties of "working together" as an industry to address issues such as these. History has revealed impediments to developing consensus amongst all stakeholders. However, we must point out that none of the current pricing and pooling provisions came about without a great deal of work by the industry. If we are truly at a crossroads in the industry (as testified to by many at the hearing) then we *must* work together to find solutions to maintain the dairy industry in California. We have no choice but to do so.

Any attempt by the Department to adapt the classified pricing system to address these larger industry issues would be a dramatic shift in policy. The classified prices should be based on Department data pertaining to manufacturing cost allowances, yields, f.o.b. adjusters, etc. A reduction in class prices in order to provide incentives for plant capacity would put the

Department in a position of setting policy — a role that is properly filled by industry stakeholders. We have proposed the appropriate venue to do just that.

We thank you for the opportunity to file a post-hearing brief and look forward to the Department's hearing determination.

Very truly yours,

Michael L. H. Marsh, CPA
Chief Executive Officer

cc: Board of Directors, Western United Dairymen

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CCC ANNOUNCES REVISED TERMS AND CONDITIONS FOR MILK PRICE SUPPORT PROGRAM PURCHASES

WASHINGTON, April 7, 2006 - The U.S. Department of Agriculture's Commodity Credit Corporation (CCC) today announced the issuance of a newly revised contract for purchasing bulk dairy commodities under the Milk Price Support Program. Bulk dairy products include salted butter, block cheddar cheese, American cheese packed in barrels and nonfat dry milk.

In its efforts to update program requirements, USDA's Farm Service Agency (FSA) held meetings with dairy industry associations, representatives, trade groups and government agencies to obtain input on this new contract and related procedures. As a result, CCC has been able to streamline purchasing specifications and develop requirements that more closely adhere to commercial practices. Some of the streamlining improvements include eliminating outdated packaging requirements; enhancing grading guidelines; allowing for use of electronic transmission of data for upcoming purchase requests; updating references to FSA's Web site and generally making the contract more user-friendly and reflective of current industry practices.

More information on the Milk Price Support Program, CCC programs, and other FSA services can be found on FSA's web site at http://www.fsa.usda.gov/daco/Announcement/Dairy/dairyannon.htm and at http://www.fsa.usda.gov.

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May 10, 2006

Mr. David Ikari, Chief
Dairy Marketing Branch
California Department of Food and Agriculture
560 J Street, Suite 150
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Subject: **Cost Study Consulting Report #1**

Dear Mr. Ikari,

The Department's Dairy Marketing Branch engaged CPS Human Resource Services (CPS) to review, analyze and make recommendations on the methodology and procedures for the release of aggregated data publications, including the allocation of processor penalties, and the documentation and performance of internal operating procedures. This is the first of two reports. The staff on this engagement are Dale Montgomery, CPA, and Jeff Mikles, PMP.

Scope and Methodology

The scope of this first report covers only annual cost study update methodology and presentation. Due to the limited amount of time to research and prepare this first report, our methodology was restricted to performing the following tasks:

- Reviewed applicable California Food and Agricultural Code statutes, Branch cost study procedures, and specifically the methodology and presentation method used to aggregate the annual cost studies and the manner in which annual updates to energy and labor costs are released and incorporated into the cost display;
- Reviewed past cost study consulting reports and communications with dairy industry associations; and
- Interviewed Manufacturing Cost Unit staff, dairy industry economists and executives from producer and processor associations, and a large cheese manufacturer.

Study Results

The following discusses the results of our review of the annual update methodology, update presentation format and penalty allocation methodology, and presents improvement recommendations.

Annual Update Methodology

The primary reason given for preparing annual updates is that the process of completing the annual cost studies is significantly slower than escalating manufacturing costs. In the preparation of annual cost studies, the Manufactured Cost Unit (MCU) utilizes data that manufacturers provide from their annual financial audit. These audits are typically completed between March and May of each year and are provided to the MCU upon completion. Typically, the cost studies are not completed, compiled and available for distribution until November.

The MCU advised CPS that delayed receipt of audited processor data is the primary reason it takes so long to complete the annual cost studies. CPS learned that only one processor submits data electronically soon after the audit is completed, as recommended in a 2002 review of cost study procedures and processes.

Our inquiries into the origins of the annual updates to cost studies resulted in less than conclusive results. Department staff indicate that the updates have been performed for more than 21 years, but voiced uncertainty as to what originally prompted the updates as they are not required by statute or regulations.

Currently, updates are limited to replacing historic unit cost data for labor, energy and packaging with current unit cost data and leaving the remaining elements of the original cost study unchanged. Depending upon the commodity in question, the cost components of labor, utilities and packaging make up approximately 50% of the total manufacturing cost incurred.

Challenges to the reasonableness of this process have arisen citing that it is unreasonable to choose only 50% of the cost elements, while ignoring change to other costs and production volume. Moreover, in our opinion, adjustments should not be based on the application of current year labor, energy and packaging costs to prior year production volume. Instead, a complete cost study should be performed.

Suggestions offered by staff and industry representatives to improve the data quality and timeliness of report preparation include the following:

- The development of an energy index, thus eliminating the need for additional hearings to adjust the "make allowance" as significant changes in the cost of energy occur
- Request processors to submit unaudited production and cost data (volume, labor and energy costs) electronically on a monthly basis
- Request outside auditing firms to prepare a mandated cost study report as part of the annual audit, submitting data in a standardized format

In our opinion, if the annual cost studies were completed in a more timely manner as previously recommended, updates would be unnecessary.

Recommendations

CPS recommends the following:

1. MCU should implement the recommendations made in the July 2002 consulting report, which include:
    a. MCU should communicate the planning, execution and closing of the annual cost studies, including data requirements and schedule, to the highest level of management.
    b. Require processors to submit data on a monthly basis in an electronic format MCU prescribes, rather than upon completion of annual audits. This will allow MCU staff to review the reasonableness of the data and trends on an ongoing basis.
    c. If necessary, ensure industry compliance with the above through regulation.
2. Abandon the practice of preparing annual updates.
3. The MCU should change the purpose of on-sight processor visits to ensuring the accuracy of data submitted on a periodic test basis, rather than collecting data to be used in the completion of cost studies.

Annual Update Report Presentation Format

During our interviews of various industry representatives, readers of the annual update reports have indicated that the report presentation is confusing and does not clearly distinguish between updated data and data that remain unchanged from the original cost study.

The updates that we reviewed appeared to be replications of prior reports without change to format and narrative data presented. There were only slight, unmarked changes to the numbers reported with no explanations.

If the updates are eliminated as previously recommended, revising the reports is a moot point. However, if the updates are continued, CPS recommends the changes below.

Recommendations

If updates are continued, CPS recommends that MCU:

4. Revise the update process in the following manner:
    a. Provide a transmittal letter that briefly explains the purpose of the report, the period covered and the attachments.
    b. Modify the report headers to clearly indicate the nature of the report (i.e. an annual cost study, an update and the period covered).
    c. Contrast and explain differences between the updated numbers and the prior numbers.

Penalty Allocation Methodology

As part of this engagement, CPS was requested to examine the methodology the MCU uses to include penalties in cost studies. This concern has recently come to light because of a large penalty a cheese manufacturer incurred in 2004 that was included in its manufacturing costs as part of its cost study.

Food and Agricultural Code section 61442, which authorizes the Department to collect and summarize cost data from California dairy manufacturing plants, does not provide clear guidance as to which costs are includable in cost studies used to establish reasonable manufacturing cost allowances.

The argument has been made that penalties are not a "reasonable" cost of doing business and therefore should not be included in manufacturing cost.

Our review of the cheese manufacturer's penalty and their stated efforts to comply with regulatory requirements indicates the penalty incurred was far less that the cost of compliance and should probably be included as a manufacturing cost.

This is not to say that CPS recommends that all fines and penalties should be treated as reasonable manufacturing costs. In the absence of clear legal authority for including or excluding such items in manufacturing cost, the MCU will need to evaluate each case based upon the facts and circumstances and make a determination. Such determinations will probably be the subject of future criticism and challenge.

Recommendations

CPS recommends that the MCU:

5. Seek clarification from the Department's legal resources as to the proper handling of penalties.
6. In the interim, the MCU should note the occurrence and reason for penalties, any mitigating circumstances, and the respective treatment in the cost studies.

If you have any questions concerning the work performed or the results, please contact Dale Montgomery at 684-6311 or me at 263-3614 x3040.

Sincerely,

David M. Caffrey
CPS Senior Manager

cc: Kelly Krug
Venetta Reed
Dale Montgomery
Jeff Mikles

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May 19, 2006

Rachel Kaldor
Executive Director
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Dear Rachel:

The Board of Directors of Western United Dairymen has directed me to invite the Dairy Institute of California to co-host a public dialogue on California dairy pricing and pooling policy with our association. The intent and purpose of such an event would be to attract dairy producers, dairy processors, and dairy cooperatives to engage in thoughtful discussion with respect to the many pooling and pricing issues that face the California dairy industry.

As envisioned, the Dairy Institute and Western United would collaborate on developing a date and a proposed agenda, as well as potential topics for industry discussion. We believe that such an industry-wide dialogue is critical given the many challenges we face in the California business climate.

Some of the potential issues for discussion might be:

Producer viability
Plant capacity and incentives for plant construction
Pooling and pricing
Legislative initiatives
How to best meet shared environmental and energy challenges

We look forward to discussing this idea with you in greater detail. If you have any questions, please give me a call.

Very truly yours,

Michael L. H. Marsh, CPA
Chief Executive Officer

cc: Case Van Steyn