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STATE OF CALIFORNIA

DEPARTMENT OF FOOD AND AGRICULTURE

DAIRY MARKETING BRANCH

SECRETARY OF STATE'S OFFICE

1500 11TH STREET

AUDITORIUM

SACRAMENTO, CALIFORNIA

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9:00 A.M.

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PANEL MEMBERS

Ms. Hayley Boriss, Associate Agricultural Economist

Ms. Candace Gates, Research Manager II

Mr. Tom Gossard, Agriculture Economist

Mr. David Ikari, Chief, Dairy Marketing Branch

STAFF

Ms. Marie Caron-Lyles, Associate Government Program Analyst

ALSO PRESENT

Mr. Kevin Abernathy, California Dairy Campaign

Mr. John Bedrosian, United Western Grocers

Mr. Dennis Brimhall, Super Store Industries

Mr. James Dolan, Driftwood Dairy

Dr. James Gruebele, Land O'Lakes

Ms. Sharon Hale, Cyrstal Cream and Butter Company

Mr. Evan Kinser, Dean Foods Company, Inc.

Ms. Tiffany LaMendola, Western United Dairymen

Mr. Albert Nunes, Genske Mulder

Dr. William Schiek, Dairy Institute of California

Mr. James Tillison, Alliance of Western Milk Producers

Mr. William C. Van Dam, Milk Producers Council

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PROCEEDINGS

HEARING OFFICER AYNES: Good morning. This hearing will now come to order. The California Department of Food and Agriculture has called this public hearing at the California Secretary of State Building, 1500 11th Street, Sacramento, California, on this day, Tuesday, December 5th, 2006, beginning at 9 a.m.

My name is Jim Aynes and I'm an attorney for the California Department of Food and Agriculture. I've been designated as the hearing officer for today's proceedings.

The Department received a petition from Alliance of Western Milk Producers on April 18th, 2006, and a petition from Western United Dairymen on April 21st, 2006. Both petitions requested the public hearing to consider changes to the Class 1 milk pricing formula.

The Department received on November 14th, 2006, one alternative proposal from the Dairy Institute in response to the Alliance of Western Milk Producers' and Western United Dairymen's petitions.

During a prehearing workshop conducted in the Department's auditorium on November 28th, 2006, the Department provided an analysis of alternative concepts and proposals. A copy of the analysis will be entered into the record of this hearing as exhibits.

Accordingly, the purpose of this hearing is to consider the changes as proposed in the petitions from Alliance of Western Milk Producers and Western United Dairymen and the alternative proposal that's offered by the Dairy Institute.

Testimony and evidence pertinent to the call of the hearing will now be received. Anyone wishing to testify must sign the hearing witness roster located at the sign-in table. Oral testimony will be received under oath or affirmation. CDFA staff member Karen Daper will be available -- whoops.

CDFA staff member Karen Daper will be available at the sign-in booth -- sign-in table -- will be available at the sign-in table to provide assistance.

As a courtesy to the Panel, Department staff and the public, please speak directly to the issues presented by the petitions and avoid personalizing any disagreements. Such conduct does not assist the panel in its attempt to effectively address the sophisticated economic and regulatory issues presented by the petitions.

For the record, testimony given at this hearing does not necessarily reflect the position of the Department regarding the proposed amendments.

Please note that only those individuals who have testified under oath during the conduct of the hearing may request a post-hearing brief period to amplify, explain or withdraw their testimony. Only those individuals who have successfully requested a post-hearing brief period may file a post-hearing brief with the Department.

And I believe we will be deciding at the end of the testimony whether or not there will be post-hearing briefs.

The Hearing Panel has been selected by the Department to hear testimony, receive evidence, question witnesses, and make recommendations to the Secretary. Please note that questioning witnesses by anyone other than members of the Panel is not permitted.

The Panel's composed of members of the Department's Dairy Marketing Branch and include David Ikari, Branch Chief; Tom Gossard, Senior Agriculture Economist; Candace Gates, a Research Manager; Hayley Boriss, Associate Agricultural Economist.

I'm not a member of the Panel and I will not be taking part in any decision relative to the hearing.

The hearing reporter is Jim Peters from the firm of Peters Shorthand Reporters located in Sacramento. A transcript of today's hearing will be available for review at the Dairy Marketing Branch headquarters located in Sacramento at 560 J Street, Suite 150. Anyone desiring copies of the transcript of today's hearing must purchase them directly from Peters Shorthand. Their address is

3336 Bradshaw Road, Suite 240, Sacramento California.

At this time the Dairy Marketing Branch will introduce the Department's exhibits.

Marie, would you state your name, spell your last name for the record.

ASSOCIATE GOVERNMENT PROGRAM ANALYST CARON-LYLES:

My name is Marie Caron-Lyles. Last name is spelled C-a-r-o-n hyphen L-y-l-e-s.

Mr. Hearing Officer, my name is Marie Caron-Lyles. I am an analyst with the Milk Pooling Branch of the California Department of Food and Agriculture. My purpose here this morning is to introduce the Department's composite hearing exhibits numbered 1 through 43.

Relative to these exhibits, previous issues of exhibits --

HEARING OFFICER AYNES: Marie, can I swear you first.

ASSOCIATE GOVERNMENT PROGRAM ANALYST CARON-LYLES:

Pardon me?

Okay.

(Thereupon Ms. Caron-Lyles was sworn, by the Hearing Officer, to tell the truth, the whole truth and nothing but the truth.)

ASSOCIATE GOVERNMENT PROGRAM ANALYST CARON-LYLES:

Yes, I do.

Start over?

HEARING OFFICER AYNES: Yes.

ASSOCIATE GOVERNMENT PROGRAM ANALYST CARON-LYLES:

Mr. Hearing Officer, my name is Marie Caron-Lyles. I am an analyst with the Milk Pooling Branch of the California Department of food and Agriculture. My purpose here this morning is to introduce the Department's composite hearing exhibits, numbered 1 through 43.

Relative to these exhibits, previous issues of Exhibits 8 through 43 are also hereby entered by reference.

The exhibits being entered today have been available for review at the offices of the Dairy Marketing Branch since the close of business on November 28th, 2006. An abridged copy of the exhibits is available for inspection at the back of the room.

I ask at this time that the composite exhibits be received.

Mr. Hearing Officer, the exhibit next in order is a document titled "Revised Summary of Analysts," Exhibit No. 44.

Mr. Hearing Officer, the next exhibit in order is a document titled "Information Request at the Prehearing Workshop held on November 28th, 2006," Hearing No. 45.

And, Mr. Hearing Officer, the exhibit next in order is a document titled "Table 1 - In-Plant Usage of California Producer, Handler, Milk, Exempt and Non-exempt," hearing Exhibit No. 46.

HEARING OFFICER AYNES: The Department's exhibits will be identified as composite Exhibit 1 through Exhibit 43. And the other exhibits will be Exhibit 44, Exhibit 45 and 46.

Does the Panel have any questions regarding these exhibits?

(Thereupon the above-referenced documents were marked, by the Hearing Officer, as Exhibits 1-46.)

ASSOCIATE GOVERNMENT PROGRAM ANALYST CARON-LYLES: Mr. Hearing Officer, I also request the option to file a post-hearing brief. And this concludes my testimony.

HEARING OFFICER AYNES: In the event that post-hearing briefs are allowed, you will be granted.

ASSOCIATE GOVERNMENT PROGRAM ANALYST CARON-LYLES: Thank you.

HEARING OFFICER AYNES: Thank you.

Does anyone in the audience have any questions regarding the content of the Department's exhibits? Please recognize the questions are limited to the purpose of clarification.

Cross-examination of the Department staff is not permitted.

Please identify yourself and your organization for the record before asking any questions?

I see no questions.

Alliance of Western Milk Producers and Western United Dairymen each now has 45 minutes to make their presentation in support of their petition.

Alliance of Western Milk Producers will now make a presentation in support of its petition. If necessary, the presentation will be followed by questions from the Panel.

Would you state your name and spell your last name for the record.

MR. TILLISON: Yes, my name is Jim Tillison, T, as in Tom, I-l-l-i-s-o-n.

(Thereupon Mr. Tillison was sworn, by the Hearing Officer, to tell the truth, the whole truth and nothing but the truth.)

MR. TILLISON: Yes, I do.

HEARING OFFICER AYNES: Did you wish to submit this document as an exhibit?

MR. TILLISON: Yes, I do.

HEARING OFFICER AYNES: That will be Exhibit 47.

(Thereupon the above-referenced document

was marked, by the Hearing Officer, as
Exhibit 47.)

HEARING OFFICER AYNES: You may continue with your testimony.

MR. TILLISON: All right. Mr. Hearing Officer, members of the Panel. My name is Jim Tillison. I'm testifying on behalf of the Alliance of Western Milk Producers and its member cooperatives. These cooperatives both supply milk to fluid processors and process fluid milk.

The proposal and position presented at this hearing was adopted unanimously by the Alliance Board of Directors.

The Alliance appreciates the Secretary calling this hearing to consider the Alliance proposal to adjust Class 1 prices to reestablish a more reasonable relationship between California and contiguous milk marketing areas.

Section 62062.1 of the California Food and Agriculture Code states:

"Any designation of a Class 1 price by any method or formula that is used to develop Class 1 prices paid to producers in various marketing areas shall provide on a calendar year basis a statewide weighted average minimum price level for a hundredweight of milk testing 3.5 fat and 8.7 solids not fat that is in reasonable relationship with minimum Class 1 prices paid to producers in contiguous states. If the statewide weighted average paid to producers are not in a reasonable relationship with Class 1 prices paid to producers in contiguous states, the Secretary shall immediately hold a hearing to consider adjustments to the Class 1 prices." And I have added emphasis in the testimony.

The Alliance members believe that a reasonable relationship between Class 1 prices has not existed for the last two years and an adjustment must be made.

The timing of this hearing indicates that the Department has determined that a reasonable relationship does not exist between the California Class 1 price and producer Class 1 prices in contiguous states. Therefore, the issue today is what adjustments must be made to reestablish a reasonable relationship on a hundredweight calendar-year basis.

CDFA data shows that neither in 2005 nor in 2006 was there a reasonable relationship between the California weighted average hundredweight producer price compared to producer hundredweight Class 1 price in contiguous states.

The chart below indicates the differences in 2005. The California weighted average price was just 7 cents higher than southern Nevada, 43 cents less than western Oregon, and 88 cents less than Phoenix, Arizona.

In 2006 the weighted average price was 11 cents less than southern Nevada, 61 cents less than western Oregon, and 81 cents less than southwest Arizona.

Therefore, the Alliance proposes to adjust the Class 1 butterfat value by subtracting an additional 2.16 cents in the butterfat portion of Class 1 formulas. This brings the fat values into a more reasonable relationship and results in an increase in the solids-not-fat and fluid carrier price components. There is general agreement on this change.

In an attempt to achieve the requirement of 62062.1 that California's producer Class 1 hundredweight price being a reasonable relationship to hundredweight prices in contiguous states, the Alliance proposal also increases the CRP adjustment factor in both the solids-not-fat and the fluid carrier portions of the Class 1 formula from 46.4 cents to 85 cents. Together, these adjustments result in the following changes in California's weighted average producer Class 1 price relative to producer prices in contiguous states.

In 2005, it would have resulted in 46 cent a hundredweight price above the southern Nevada price. In the western Oregon price it would have been 4 cents less per hundredweight. And in the Arizona price, which is the

Phoenix price, it would have been 49 cents less -- still had a 49-cent deficit.

In 2006 the difference would be 28 cents above southern Nevada Class 1 prices, 22 cents below western Oregon Class 1 prices, and 42 cents below the southwest Arizona prices.

The relevance of historical price data and comparisons: The Department has provided extensive analysis of the various proposals submitted for this hearing. The analysis covers five years and includes averages. While interesting, the Alliance submits that the only relevant data on which CDFA should be basing its decision is the most recent calendar year. The intent of the Food and Agriculture Code 62062.1 is clear: Class 1 prices should be in a reasonable relationship on a calendar year basis.

Five-year averages don't really tell the story. For example, the five-year average between the current weighted average California Class 1 price in Medford, Oregon, is a negative 26 cents, but in 2006 the average difference is 76 cents. In 2002 the average difference was a negative 6 cents, in 2003 a positive 36 cents, in 2004 there was no difference, and in 2005 the difference was negative 81 cents. The year-to-year differences are due to CME cash prices used in California compared to the federal order use of NASS prices and the lag between those prices, CME price volatility which exacerbates the effect of the price lag, and the higher of CRP versus the higher of Class 3 or Class 4 skim milk values. The tables below compare current Class 1 formula and the Alliance proposal both projected backwards to the historic federal order prices.

Difference weighted average Class 1 prices versus Medford, Oregon: In 2002 was a negative 6 cents; 2003, a positive 36 cents; no difference in 2004; 2005, a negative 81 cents; 2006, a negative 76 cents.

The difference between the northern California Class 1 prices versus Medford, Oregon: And this basically shows the current price and the Alliance proposal impact. Currently a negative 19 cents in 2003; a positive 23 cents in 2004; a negative 13 -- I'm sorry -- in 2003; a negative 13 cents in 2004; a negative 94 cents in 2005; and a negative 90 cents in 2006. For an average of a negative 36 cents.

The Alliance proposal is a positive 20 cents compared to Medford; positive 62 cents compared to Medford; a positive 26 cents; a negative 55 cents; and a negative 51 cents.

And then you can see the table below as far as southern California's concerned. I won't bore you by reading those differences.

My point is that each year CDFA is required to take a look at the Class 1 price relationships. If the relationships are not reasonable, the Department is required to hold a hearing. So, should the Secretary make the adjustment recommended by the Alliance and it results in 2007 Class 1 producer prices not being in a reasonable relationship, another hearing should be held.

The non-issue of southern Nevada: Southern Nevada milk, either bulk or packaged, is not an issue for California producers or processors. According Mark French, Executive Director of the Nevada Dairy Commission, no packaged milk from Las Vegas is moving into southern California. In fact, it can be argued that Las Vegas is a deficit market with both bulk milk and packaged milk moving into the area rather than out of the area.

To support this statement, I have attached notes provided to me from the October 24th meeting between representatives from the Nevada Dairy Commission, from the Department, and from the California dairy industry. At the meeting the following data was provided regarding the Nevada market for packaged milk:

Packaged milk:

62 percent of packaged milk is packaged in Nevada and sold in Nevada.

21 percent of packaged milk is packaged in California and sold in Nevada.

7 percent of packaged milk is packaged in Utah and sold in Nevada.

8 percent is packaged in Arizona and sold in Nevada.

And 1 percent of the milk is packaged in Montana, believe it or not, and sold in Nevada.

There used to be dairies that served the Las Vegas market in Nevada, but they are now gone. Most of the milk produced in southern Nevada now goes into California. Those dairies were never built with the intent of shipping milk to Las Vegas. They were always supposed to ship milk to California. And I think we all know who owns those dairies and what dairy plant in southern California that milk is going to.

The Dean Foods plant in Las Vegas gets:

30 percent of its milk from California.

Some milk, about 11,000 pounds per day, from northern Nevada. But it's not efficient to ship that milk because it has to travel 400 to 450 miles from Fallon; costs about $2 per hundredweight to transport; because the state regulated market with its little bit of milk is the only milk that is price regulated in the Las Vegas area.

All other milk coming into Las Vegas plants comes from out of the state.

Most of the milk coming into the Anderson-Erickson plant is from Utah. No Nevada-produced milk is available to run through the Anderson plant. There are no plans to build dairies in Nevada to ship milk into Las Vegas at this time.

I urge the members of the Panel and the Secretary to thoroughly review the meeting summary attached. Clearly, southern Nevada/Las Vegas market considerations should not be a major factor in determining what adjustments should be made to the California Class 1 producer price.

Other proposals:

Three proposals have been submitted to the Department for consideration: The Alliance's, Western united's, and the Dairy Institute's. The tables below compare them to the historic federal order prices. And, again, I won't bother reading the tables. I'll simply look at 2006 because that's the year we're concerned with.

The current price is 76 cents below Medford, Oregon; the Alliance proposal provides a 37 cent price below Medford, Oregon; the Western United price is 32 cents below Medford, Oregon; and the Dairy Institute results in a price that is 70 cents below Medford, Oregon.

The difference between the northern California

Class 1 prices less Medford:

And again you've got the current price in 2006 is a negative 90 cents; the Alliance results in a negative 51 cents; Western United, a negative 46 cents; and the Institute, a negative 84 cents.

As far as southern California is concerned:

In 2006 the average is a negative 83 cents for the current formula; the Alliance formula compared to the Yuma price is a negative 44 cents; the Western United proposal is a negative 39 cents; and the Dairy Institute's proposal results in a negative 77 cents.

The Western United proposal is very similar to the Alliance proposal. And the Alliance would not be opposed to it being adopted.

The Dairy Institute proposes adding a whey factor into the cheese CRP formula. It says that the purpose in doing this is so California Class 1 prices better "track" federal order Class 1 prices. Its proposal adds what the Alliance would characterize as a make allowance into the cheese CRP formula.

The current CRP formulas are the commodity values times yield. The cheese CRP formula is CME times 9.8 plus CME butter less 10 cents, to make it equivalent to grade B butter, times .27.

The butter powder CRP formula is CME times 1.2

yield times 3.5 plus the CWAP times .99 times 8.7.

The Dairy Institute proposes to modified the cheese CRP by adding a Western Mostly dry whey prices times 5.8 yield less a make allowance of 85 cents. The sole purpose of the 85-cent deduction from it is to reduce the value of dry whey in the CRP. No other commodity value in either of the CRP formulas has a similar adjustment.

Table 5 of the Summary Analysis of Estimated Impacts of Petitions and Alternative Proposals -- and I'm not sure what the exhibit number would be on that, if it's 44, or 45 or 46 -- only compares how often California and federal order Class 1 prices use the same commodity to determine the higher of bases for calculating Class 1 prices. It is not an effective measure of how milk prices track.

When you compare actual California Class 1 prices under any of the proposals to the federal order Class 1 base prices -- I'm sorry, Class 1 prices in Medford, Oregon -- the result shows that none, including the Dairy Institute's, provide significantly better tracking than the current formula on a month-to-month basis.

As the chart shows, adopting the Institute's proposal would do nothing to improve the actual tracking of Class 1 prices and it does not establish a reasonable relationship between California producer prices and those in contiguous states.

To lessen the positive impact of adding a whey value to the cheese CRP formula, in addition to the 85 cent make allowance deduct, the Institute proposes reducing the CRP adjuster in the nonfat solids and fluid carrier portions of the Class 1 formula by a total of 63.4 cents. That is moving it from a positive 46.4 cents to a negative 17 cents. This does nothing to improve how Class 1 prices track, and it significantly reduces the California Class 1 price in relation to surrounding Class 1 prices when the butter powder CRP is the higher of.

The Alliance is opposed to adding a whey factor to the cheese CRP. At the federal level, producer organizations are struggling with how to get away from changes in manufacturing allowances in cheese and butter powder formulas reducing Class 1 milk values. California should not be considering adding one to the Class 1 formulas. It is the market value of commodities that should determine the higher of CRP.

The Alliance urges the Department not to adopt the Dairy Institute's proposal.

In summary, the Alliance proposal reestablishes reasonable minimum producer Class 1 price relationships while maintaining the competitive advantage that California processors have in the marketplace. We urge CDFA to adopt the Alliance proposal in its entirety and to implement it as soon as possible.

That ends my testimony. And I'd like to request the ability to file a post-hearing brief.

HEARING OFFICER AYNES: If there is a post-hearing brief period, you may file a post-hearing brief.

MR. TILLISON: Thank you.

HEARING OFFICER AYNES: Are there questions from the panel?

AGRICULTURAL ECONOMIST GOSSARD: Mr. Tillison, on page 5 of your testimony in the bulleted section, you state Dean Foods plant gets 30 percent of its milk from California, a certain amount from northern Nevada, and then all other milk comes from out of state.

When you say out of state, you're not including California; you're meaning states other than California and Nevada?

MR. TILLISON: Yes.

AGRICULTURAL ECONOMIST GOSSARD: On page 4 of your testimony, at the very top, you have a sentence that begins, "The year-to-year differences are due to CME cash prices used in California compared to the federal orders use of NASS prices and the lag between those prices."

So in your opinion, the fact that the federal order has used a skim whey powder value in their formula and that they used barreled cheese as well as block has no effect on these differences?

MR. TILLISON: Well, that's why I indicated that we're using the CME, they're using the NASS price. But I do not believe that the whey value has a significant difference. What I'm trying to do is compare apples and apples. And when you look at the CME cheese price, we use block only, they use a barrel block combination. And because of the way the NASS prices are market prices -- actual market prices, not cash prices, there's a lag period involved in the process.

AGRICULTURAL ECONOMIST GOSSARD: Have you done any formal statistical analysis in terms of how well they track in terms of analysis of variance, R square or anything like that?

MR. TILLISON: No, I haven't. All I've done is compared the Class 1 prices in the federal system to the Class 1 prices on any of the proposals being put before you. And none of them track. Frankly, even when you plug the CME values into the federal formulas, the tracking doesn't become that much closer. But, no, I haven't done any R squared analysis or any R cubed analysis or the square root of R analysis.

(Laughter.)

AGRICULTURAL ECONOMIST GOSSARD: No further questions.

HEARING OFFICER AYNES: Are there any further Panel questions?

RESEARCH ANALYST II GATES: Mr. Tillison, I have a question. And that is regarding, what is your definition of a reasonable relationship? You know, it was used quite a bit within your testimony. What is that range or what do you see that --

MR. TILLISON: Well, I think frankly that that's one of the real challenges that the Department faces is defining what is reasonable. My tendency is to look at the price of the milk -- the bulk milk in the contiguous area and what it would take to move that milk into California.

Frankly our proposal is pretty generous in terms of comparing to 2006 and what it does. It doesn't close the gap to zero. I think it adjusted Class 1 prices while maintaining a competitive price for our processors in terms of selling milk outside of the State of California.

So obviously one measure of "reasonable" is to look at the bulk milk price and what it costs to move in to California, because frankly I think that's an issue that concerns some producers.

As far as packaged milk coming into California, again you have to look at the cost of moving the packaged milk. We did contact Kings County Trucking. They indicated that the cost of moving a gallon of milk from Nevada, for example -- I'm sorry -- from Yuma, Arizona, for example, to Los Angeles would be about 22 cents a gallon.

So I think when you look at the Alliance proposal and add 22 cents a gallon to it, it's a pretty reasonable proposal.

RESEARCH ANALYST II GATES: Thank you.

HEARING OFFICER AYNES: Are there any further panel questions?

DAIRY MARKETING BRANCH CHIEF IKARI: Yes, I have got one.

Mr. Tillison, in looking at your tables on 5 and 6, you put down the differences between the current -- and this goes to the reasonable relationship. On 2006 Western United had the -- California-weighted average less Medford had the lowest difference. All the proposals would reduce the difference of the California price versus the current. So in trying to make that judgment of which is the best proposal, do we consider -- what do we consider? What objective measure do we consider? You mentioned the transportation costs. Is that the only thing we consider?

MR. TILLISON: Well, number one, I think that 62062.1 is pretty clear. And what it basically says is your primary consideration should be the weighted average costs in the calendar year.

In terms of other considerations, the simple fact that the Alliance proposal and the Western United proposal, while reducing the difference, still maintains a difference, to us indicates that it would provide a competitive price for California processors in northern California, where the primary concern isn't bulk milk coming into the state. The primary concern is competition from packaged milk.

And when you add the transportation costs of moving packaged milk down to Sacramento or down to San Francisco to what the Alliance is proposing, I think our processors still maintain a competitive advantage.

I think that the Dairy Institute proposal in nobody's mind can, in our opinion, establish -- provide a reasonable relationship with the Class 1 producer price in northern -- in Medford, Oregon.

DAIRY MARKETING BRANCH CHIEF IKARI: Without sales information of packaged milk from out of state, how do we know if the Department makes a change whether or not there's more packaged milk coming in, whether or not the changes have made California less competitive with out-of-state packaged products?

MR. TILLISON: I think what you need to do is look at the -- number one, the producer price of Class 1 milk; number two, the distance from a packaging facility, Medford, Oregon, to a significant market in California.

As I said, I think the negative 36 cents that the Alliance proposal -- or 37 cents that the Alliance proposal provides allows a processor in Sacramento to be competitive with milk coming in to Redding, for example.

But since you don't have the data and we don't have the data, my belief is is that our proposal provides a fair adjustment to the price that will benefit producers and not harm processors.

DAIRY MARKETING BRANCH CHIEF IKARI: Did the Alliance consider that it may be -- a co-op operating in a federal order, it may be in their interest to actually sell it -- even what it costs in money, their value to their co-op is better than if they would market the milk as Class 4 -- or Class 3.

MR. TILLISON: I don't think the data supports that.

DAIRY MARKETING BRANCH CHIEF IKARI: You consider that --

MR. TILLISON: Because in a federal order the only price that matters is the uniform blend price. When you're talking about a cooperative that's marketing packaged milk -- and that's what I assuming you're talking about -- if they package milk and sell it into California, they have to account for the pool in Oregon for that milk in the order.

DAIRY MARKETING BRANCH CHIEF IKARI: Correct. But the co-op itself, might it be possible that it accounts for the pool at the federal order Class 1 price? But a co-op from a profit and loss statement is better off than if it would have marketed it as a Class 4 -- or Class 3 in a federal order.

MR. TILLISON: Certainly in 2006 that was not the case. And, again, I don't believe that an organization like Darigold, which is frankly I think the only organization that's packaging milk in Oregon, has an advantage in doing that.

DAIRY MARKETING BRANCH CHIEF IKARI: So it's your belief that if the Department adopted the Alliance proposal, there would be no unintended consequences in terms of the California competitiveness of fluid products?

MR. TILLISON: That's my firm belief. Plus, as I said before, that's not supposed to be the primary decision on -- the basis on which you make the decision. And the intent of the law is very clear. And, that is, that, number one, is the reasonable relationship in existence? The current formula does not provide a reasonable relationship. The Dairy Institute proposal does not provide a reasonable relationship. The Alliance proposal and the Western United proposal provide more reasonable relationships than any of the other -- than the current or the Dairy Institute.

DAIRY MARKETING BRANCH CHIEF IKARI: I have no further questions.

HEARING OFFICER AYNES: Further questions from the Panel?

Questions on how to operate the microphone?

(Laughter.)

MR. TILLISON: This hearing would run a lot faster if we just had a regular switch.

ASSOCIATE AGRICULTURAL ECONOMIST BORISS: You had said that your fine with the Panel adopting the Alliance's or the Western United's proposal as well.

Is there any reason that your numbers of 216 and .850 are better than, say, .9 to .02?

MR. TILLISON: No.

ASSOCIATE AGRICULTURAL ECONOMIST BORISS: Okay. So either way you're fine --

MR. TILLISON: They're pretty close.

ASSOCIATE AGRICULTURAL ECONOMIST BORISS: Okay.

And what about the Institute's proposal -- what's your feeling of -- when you add the dry whey but maybe not the 17 cent decrease, is it still your feeling that it won't track better and that there won't be a reasonable relationship in prices?

MR. TILLISON: Basically it would track better in 2000 and 2006 if they didn't take away the 17 cents. Certainly it would have tracked better historically. As far as 2006 is concerned, it's pretty close.

ASSOCIATE AGRICULTURAL ECONOMIST BORISS: But you would still wouldn't support adding a whey factor on its own?

MR. TILLISON: No, I don't think it's a -- I don't think that you want to introduce a factor into a formula that can result in a deduct from the value of the other commodities. Currently -- as I said in my testimony, Commodity Reference Price is simply commodity value times yield. And all of a sudden you're creating a situation where if the whey price falls below the 85 cents -- you know, multiply it times five eight, is below the 85 cents, then suddenly you're actually reducing the value of solids not fat in the formula. And that really doesn't have anything to do with the value of Class 1 milk in my opinion.

ASSOCIATE AGRICULTURAL ECONOMIST BORISS: That's all.

HEARING OFFICER AYNES: Any further panel questions?

Seeing none.

Thank you for your testimony.

MR. TILLISON: Mr. Hearing Officer, can we go off the record for just a minute please?

HEARING OFFICER AYNES: Yes, we can go off the record.

(Thereupon a recess was taken.)

HEARING OFFICER AYNES: All right. We're on the record.

Western United Dairymen will now make the presentation in support of its petition.

Would you state your name and spell your last name for the record please.

MS. LaMENDOLA: Tiffany LaMendola, L-a-m-e-n-d-o-l-a.

(Thereupon Ms. LaMendola was sworn, by the Hearing Officer to tell the truth, the whole truth and nothing but the truth.)

MS. LaMENDOLA: I do.

HEARING OFFICER AYNES: And do you wish to submit this document as an exhibit?

MS. LaMENDOLA: Yes, please.

HEARING OFFICER AYNES: Okay. Your document is identified as Exhibit No. 48.

(Thereupon the above-referenced document was marked, by the Hearing Officer, as Exhibit 48.)

HEARING OFFICER AYNES: You may begin to testify.

MS. LaMENDOLA: I'd like to mention upfront that our testimony is fairly lengthy. I don't plan on reading it all today. I would like it all submitted into the hearing record.

Also, we've referenced a few sections of the Food & Ag Code, in which I'll paraphrase in order to save time.

Mr. Hearing Officer and members of the Hearing Panel. My name is Tiffany LaMendola. I'm the Director of Economic Analysis for Western United Dairymen. Our association is the largest dairy producer trade association in California, representing approximately 1100 of California's 2,000 dairy families. We're a grass roots organization headquartered in Modesto, California. An elected board of directors governs our policy. The board of directors met April 21st, 2006, to approve the position we will present here today.

Our proposal calls for a 40 cent per hundredweight increase in northern and southern California Class 1 price. At the same time our proposed changes will lower the northern and southern California Class 1 fat price by approximately 2 cents per pound and increase the adjuster to the Commodity Reference Price. Both changes will bring California's Class 1 price into better alignment with surrounding areas and address directives laid out in the California Food and Agricultural Code.

At previous Class 1 hearings a great deal of focus was directed to one section of the code, 62062.1. The Panel made it clear in their report that neither this section nor any other section should be viewed as having greater consideration or emphasis than any other statutory provision. While it's hard to ignore the fact that Section 62062.1 is the only section that directly references a Class 1 price, we will provide ample evidence that support the directives of the code in our proposal. Additionally, we will address the competitive issues surrounding various areas in California.

In our process of reviewing the statutory requirements of the Food and Ag Code that are pertinent to this hearing, one thing was clear: Different individuals will have differing opinions as to what the code means. We'll provide our interpretation and, in doing so, justification for our proposed increase in Class 1 price.

Section 61801: The production of market milk is hereby declared to be a business affected with public interest.

Clearly, the production and marketing of milk is a public interest. We agree that as a public interest, the needs of producers, processors, and consumers must be considered. To this end, we spent a great deal of time considering what impact our proposal will have on these competing interests.

Section 61802(e): It is the policy of this state to promote, foster, and encourage the intelligent production and orderly marketing of commodities necessary to its citizens.

In the past, out-of-state bulk milk shipments and out-of-state package shipments into California have been cited as evidence of artificially high Class 1 prices fostering the disorderly marketing of milk. Because of this, we'd like to spend some time reviewing both occurrences.

Competition from Out-of-State Packaged Products:

A major focus at the last Class 1 hearing was competition from an unregulated processor in Arizona who had predatorily captured market share in southern California. At the time, this processor was not required to pay a regulated price for milk supplying either his plant solely supplying California or his producer-distributor plant. As a result of this loophole, he was always able to undercut the competition.

It was clear to us that the only way to adequately address this regulatory loophole was through federal legislation that imposed regulation on this handler. The passage of the Milk Regulatory Equity Act authored by Senator Dianne Feinstein and Congressman Devin Nunes, and signed into law by President Bush in April 2006, marked a major victory for the U.S. dairy industry. Western United was an integral part of this unprecedented national coalition of producer and processor groups that supported the measure.

Evidence may be provided today that should -- suggests that the Arizona bottler is still supplying portions of the southern California market. Given the Class 1 price in Yuma, Arizona, as well as high transportation costs, it's plausible that the California business is being maintained at a loss to the handler.

Major changes this year have greatly enhanced the competitive position of California processors to compete with this bottler:

First, the raw product cost advantage once enjoyed by this handler no longer exists. In 2006, southern California processors faced an average Class 1 price of 13.30 and Yuma, Arizona, Class 1 price averaged 13.98, or a 68 cents her hundredweight above southern

California Class 1 price.

Two, findings of the Department in recent transportation hearings show that transportation costs have increased, making it more costly to ship packaged product into the state.

And, third, this bottler also owns a large number of dairies. The more own-farm milk the plant uses, the greater his cost advantage. Because of the PD cap mentioned above, this advantage has been greatly reduced. In addition, it's reasonable to assume that just as the cost of production has increased for California producers, so too have the costs for this producer-handler.

Clearly, the dynamics surrounding the fluid bottler in Arizona are much different today than they were at the last Class 1 hearing. We see no reason why California's Class 1 processors would not be competitive with the adoption of our proposal. In fact, the 24 cent per hundredweight raw product cost advantage would still exist.

Finally, though we do take note of various rumors surrounding the Yuma bottler, to the best of our knowledge the rumors are unsubstantiated hearsay and should not be considered in the scope of this hearing.

Out-of-State Bulk Milk Entering California:

The threat of out-of-state bulk milk shipments into California has previously been used as justification for low Class 1 price in California. At issue here is the incentive to purchase milk from more competitive sources, which is not a direct effect of California's Class 1 prices being too high, but rather the way this more competitive milk was, and currently is, handled in the California pool.

Since April 2004, and as a result of the settlement in the Hillside-Ponderosa lawsuit, out-of-state sourced milk used for Class 1 purposes is credited at the Class 1 price and therefore is essentially exempt from pool obligations. The advantage made available by the inability to regulate interstate commerce will exist regardless of the level of the Class 1 price. With this issue placed in proper perspective, we offer some additional observations.

It should be noted that 2006 year-to-date shipments of out-of-state bulk milk used in Class 1 are down nearly 5 percent from the same period in 2005. In attempts to better understand this data, we have done a cursory review of the competitive issues at play in various out-of-state markets.

First we looked at Nevada. Based on conversations with the Nevada Dairy Commission, there's not a growing milk shed available in Nevada from which to supply California. Nevada is home to only 32 dairies. Only one dairy is left in Clark County, Nevada. According to the commission, most of the milk from Nevada coming into California originates from the Amargosa Valley and supplies Rockview Dairy in southern California. There has historically been a portion of northern Nevada bulk milk shipped into northern California. It is our understanding that these shipments are based on long-standing relationships and are unlikely to change from current levels.

According to the Nevada Dairy Commission, a new plant is under construction in Yerington. It's intended that this plant will be supplied by Nevada milk. This plant is not large, but it will give northern Nevada producers another option of where to ship their milk, likely competing with the nearby Model dairy for a milk supply. This plant will also be fully regulated by the Nevada Dairy Commission.

Given the situation in Nevada noted above and as described to us by the Nevada Dairy Commission, we do not foresee nor expect any sizable increases in bulk shipments into California. We were therefore surprised at the result when we broke out the bulk imports originating from Nevada. Though 2005 imports followed the trend we expected, we cannot account for the increases witnessed so far in 2006. We are not aware of any new dairies built in Nevada to supply California or of any major expansions in the current dairies supplying California. Likewise, the Nevada Dairy Commission is unaware of any additional exports from Nevada to California, nor of any potential source. Unfortunately, without a good explanation available to us, it's easy to assume that perhaps some of this milk has been roundtripped. This is an issue we'll discuss in greater detail later. Given the absence of any obvious explanation, we respectfully ask the Department to carefully analyze the data available to them to ascertain why reported bulk milk from Nevada has increased this year.

Arizona is the other main origin of bulk milk imports into California. CDFA data shows that while Arizona imports were up in 2005 when compared to 2006 -- I'm sorry -- when compared to a year earlier, 2006 bulk milk imports are down significantly when compared to last year.

A comparison of Arizona bulk shipments and difference between southern California Class 1 price and the Arizona blend price is shown in the chart below.

A recent downward trend is noticeable both in terms of bulk imports from Arizona and differences in prices. The spread between the two price series is usually looked at as an incentive for Arizona producers to ship their milk to California.

We note a few recent developments that may be enhancing the Arizona uniform blend price. The addition of the two large fluid plants in the Arizona pool has increased the Class 1 utilization. This has undoubtedly had the effect of enhancing the Arizona uniform price, making it less likely that producers in Arizona will seek a home for their milk in California.

Rough estimates show that the additional Class 1 production now accounted for in the Arizona pool could equate to an additional dollar twenty-eight per hundredweight added to the Arizona uniform blend price. This represents a substantial increase in revenue for Arizona producers shipping into the Arizona pool.

Further deterrents to imports from Arizona may also exist due to the high cost of transportation. Outside estimates show an estimated cost of transportation from Arizona to California of approximately a dollar twenty per hundredweight. Given the declining spread between Arizona blend and California Class 1 price, this could be a factor in the recent decline in shipments. The spread between southern California Class 1 price and Arizona blend price average 1.18 in 2004, 1.35 in 2005, and averaged only a dollar in 2006. As of August 2006, the spread was only 15 cents.

Finally, milk production growth in Arizona has not been as large as in other western states, such as New Mexico, Idaho, and California. Given the presence of a cooperative in Arizona, representing 90 percent of the producers in the state, with modern manufacturing facility that needs a supply of milk, as well as several fluid processing plants, we don't expect milk available to ship to California will grow substantially beyond what is already imported here.

Round-tripping:

The issue of round-tripping was also discussed at the last Class 1 hearing. We hope the threat and/or reality of this improper activity will not be used as rationale for rejecting our request to increase the Class 1 price. The Secretary's findings from the May 2005 Class 1 hearing clearly outline that a reduction to the regulated Class 1 price is not the appropriate mechanism to deal with round-tripping. In his determination, the Secretary highlighted the following point in his determination: And I'll only read the first one.

The Panel is in effect recommending a price answer to a regulatory problem, setting the lowest common denominator as the standard, instead of the statutory reasonable relationship to surrounding states.

We respectfully ask that the Secretary maintain his willingness to seek prosecution of any parties involved in round-tripping.

Section 61802(h): It's recognized by the Legislature that the levels of retail prices of milk and milk products paid by consumers are affected by a large number of economic and other factors apart from the minimum producer prices for market milk established under this chapter, many of which factors are not within the power of the director to regulate or control. It is essential to establish minimum producer prices at fair and reasonable levels as to generate reasonable producer incomes that will promote intelligent and orderly marketing of milk.

Clearly, the Legislature recognized a disconnect between part farm level prices and retail prices. The levels of the marketing chain from producer to retail allow for various mark-ups. We have repeatedly heard that lower Class 1 prices should be maintained because of the benefit passed on to consumers. We, along with proponents of lower Class 1 prices, have entered into the record an array of studies focusing on the price transmission between farm and retail levels.

A fairly recent study conducted by the U.S.G.A.O. office included review of recent economic studies of price transmission in the U.S. fluid milk markets. Review of 14 economic studies of price transmission found that:

Quote, "Nearly all the studies of regional and metropolitan price transmission found asymmetry in timing: The price adjustment process for price decreases much exceeded that for farm price increases. Carman in 1998 found a one-month lag for price decreases and no lag for price increases in the California markets. In a later study, Carman and Sexton, forthcoming 2005, found that for the majority of cities they analyzed, the time lags estimated for price decreases generally exceeded those for price increases. For four types of fluid milk, Carman and Sexton found that farm price decreases generally took from one to three months to be transmitted to the retail level, while price increases took no more man one month. In the California markets, the authors found that, in general, retail prices responded more quickly to farm price increases than to decreases."

The 2005 study by Carman and Sexton, using multiple analytical techniques, found that, quote, "fluid milk markets in the western United States that display noncompetitive pricing also tended to lack price transmission and show price asymmetry," end quote. Though results varied among markets, the clear take-home message is that given the complexities of pricing milk at differing models of the marketing chain, an assumption that changes to farm-level prices will be passed on to consumers in a timely fashion and at an equal level is an assumption that falls short of reality.

In a similar vein, we offer again the results from the CDFA report that shows while there may be some instances in which lower farm prices may result in lower retail prices, the instances in which the full benefit is passed on to consumers would likely be random at best. And I provided a quote from that -- the Department's study.

The purported benefit to consumer -- or, conversely, purported harm -- should not be used as justification for maintaining or lowering the current Class 1 price. The Legislature recognized the complexity in retail pricing of milk.

Statutory direction has been identified in the code to establish minimum producer prices at fair and reasonable levels as to generate reasonable producer incomes that will promote the intelligent and orderly marketing of milk in the various classes.

While changes to the Class 1 price may or may not eventually translate to changes in prices to consumers, clearly minimum prices to producers are not at fair and reasonable levels. Current minimum prices are not generating reasonable producer incomes. We recognize that low commodity prices are a result of demand and supply. Recent minimum pricing decisions point to increased milk supply and stagnant growth in capacity as reasons to lower minimum prices paid to producers. Unfortunately this shift of resources from producers to processors will only result in further consolidation.

Discussions with our members indicate that during low price periods, producers have three options:

1. Increase milk supply to maintain cash flow. This will have the effect of lowering per-unit costs. Where possible, costs will also be cut; however, given the nature of ever-increasing costs of doing business in the state, this is a difficult task.

2. Acquire additional debt and/or liquidate equity to stay afloat; or

3. Go out of business if option 1 or 2 cannot be accomplished.

Those producers that cannot achieve 1 or 2 will go out of business. Other producers, likely with larger dairies, will acquire the cows and milk production will likely continues its upward trend.

Unfortunately, the argument that during both low and high commodity price periods California's milk production has consistently increased has been used as justification for maintaining low minimum prices in California. In fact, the last hearing panel report indicated that, quote, "It's reasonable to conclude that milk revenues derived from the established minimum prices were sufficiently high enough to drive further production expansion," end quote.

California has been touted as a region of the lowest production costs in the nation. The California producers' ability to maintain a low cost of production, despite higher feed costs, has been their business decisions to increase the size of their herds in order to enjoy economies of scale. This has allowed for an abundant, consistent source of milk in California. Though basic economic principles suggest that dairy producers would not continue to expand production at an economic loss, research indicates that the statement above may not take into account other factors, besides prices, that may have led to the continued growth in California milk production. We offer a few observations on supply relationships in agriculture noted in an agricultural economics textbook that we find useful in explaining why, despite low price periods, milk production continues to expand. And I'll read just a few.

Number one: In agriculture production, important time lags exist between planting and breeding decisions and the realization of output. Two consequences follow. One is the prevailing price at the time the commodity is ready for sale may differ from the price that was expected at the time the decision to produce was made.

Number four: Under conditions of rising prices, firms may be induced to adopt new techniques that would add a somewhat faster rate than with constant or declining prices. Also, a large proportion of agricultural capital comes from retained earnings, and consequently higher prices may make it possible to finance the adoption of new techniques more rapidly. Once adopted, improved production practices usually are retained even though the price of the products subsequently declines. Farmers are not likely to discard new technologies. Hence, the supply response to a subsequent decline in price is likely to be less than to the previous increase in price. Under these circumstances, the response elasticity is higher for a price increase than for a price decline.

Though long, the above list surely does not capture all the factors in supply responses in the dairy industry.

We see a destabilizing cycle of events unfolding that is likely to compromise the intelligent and orderly marketing of milk:

My co-workers and I receive calls every day that indicate that current economic conditions are driving dairy families out of business. One dairy owner informed me that their broker alone has 23 dairies currently for sale. Certainly prices will likely come up in the future as dairy markets seem to follow cyclical trends, but the debt base being built now will not easily go away.

Fluid plants are located in areas where milk production is declining. The cost of production in these areas far outstrips the revenue necessary to stay in business. As dairies continue to relocate, the cost of the transportation system to supply the Class 1 market will continue to rise, thereby further reducing returns to producers.

In the meantime, we've heard reports of cheese manufacturers encouraging producers to switch to Grade B production in order to receive a Class 4b price for their milk. California's overbase price has been equal to or below the Class 4b price in 21 of the last 21 months. The opportunity to enjoy higher prices outside the pool is clearly attractive to those producers shipping to cheese plants.

The various outcomes above are putting pressure on the system and plummeting the industry into a precarious chain of events: As more dairies go out of business in urban areas, milk must travel farther to fluid plants. This results in additional cost to the pool to move milk, which results in lower pool prices to producers. Together, these factors are leading to the breakdown in the foundation of the pooling system and threatening the intelligent and orderly marketing of milk.

Section 62062:

In establishing the prices, the director shall take into consideration any of the relevant economic factors:

(a) The reasonableness and economic soundness of market milk prices for all classes, giving consideration of the combined income from those class prices, in relation to the cost of producing and marketing milk.

We recognize that the cost of production has rarely been used by the Department as a basis for setting minimum prices. However, given our interpretation of the code, we suggest the subject warrants discussion and consideration. A review of statewide cost of production figures and statewide mailbox prices reveal the average California producer has operated on a close to zero or negative margin in four of the last six years. Even more telling is the dramatic increase in costs that have been borne by producers in the last two years. The recent spike in feed costs will only make the situation worse.

Also, these figures do not capture the estimated

22 cent per hundredweight pool price reduction due to the recent implement -- I think it died.

I guess my testimony was too long.

Sorry. You have to listen to me a little bit longer.

We recognize the concern over plant capacity in the state. However, the resources shifted to processors will not result in additional capacity in the state. In the meantime, however, the debt base for producers is mounting. Producers have been willing to support the examination of processing costs each year. It's now time to consider the ever-increasing producer costs as well.

Albert Nunes, CPA with Genske Mulder, will be offering additional testimony to the current economic conditions faced by dairy producers.

(b) Prices established pursuant to this section shall insure an adequate and continuous supply at prices to consumers which, when considered with relevant economic criteria, are fair and reasonable.

Dairy producers have dedicated their lives to supplying an adequate and continuous supply of milk and will continue to do so, even at prices that erode equity and create debt.

If fluid retail prices in California are deemed as unfair and unreasonable, it's no fault of the dairy producer. A review of farm-level prices, retail prices, and the spread between the two in California and surrounding areas is below.

Even though farm-level prices in southern California average 7 cents per gallon lower than in Phoenix, retail prices were 40 cents per gallon higher, resulting in an average farm-to-retail spread in southern California of a dollar forty-eight per gallon, or 47 cents per gallon more than in Phoenix, Arizona. A similar situation exists in northern California. Even though farm-level whole milk prices were lower than in the Pacific Northwest, the spread between farm and retail average a dollar seventy-seven per gallon compared to only a dollar forty-eight per gallon in Portland, Oregon.

Clearly, if the Department wishes to promote lower retail prices, it needs to look at other levels of the marketing chain. The Department needs to ascertain why such large farm-to-retail spreads are maintained in California. Though fortification costs come to mind as a part of the explanation, the Department's figures indicate the added fortification costs to be zero for whole milk, 6 cents per gallon for reduced fat, 11 cents for lowfat milk. This is before fortification allowances, paid by producers, are factored in.

(c) That prices, including the prices of components in milk, established by the director for the various classes of market milk bear a reasonable and sound economic relationship to each other.

Kenneth Bailey in his book "Marketing and Pricing of Milk and Dairy Products in the United States" offers the following explanation of classified prices: And I won't read it.

It is interesting to review and discuss the three justifications for higher Class 1 prices provided above. First, higher prices for Grade A milk are used to encourage producers to switch from producing Grade B milk. It's hard to ignore the fact that Grade B production has been increasing in California. While there are undoubtedly numerous reasons for this change, clearly the recent motivation has been primarily due to the fact that producers are enticed by potentially higher prices offered for Grade B production. In fact, year-to-date Grade B production is up over 5 percent.

Bailey's second point above says that Class 1 prices must be higher in order to attract milk to fluid processing plants. Because of the statewide pooling system, producers supplying fluid plants do not receive higher regulated prices than those shipping elsewhere. Anecdotal evidence does suggest that some incentives are provided through over-order premiums paid by processors.

The only nondiscretionary incentives are provided to most producers supplying fluid plants through transportation allowances funded by the pool. With implementation of pooling, producers a commitment to ensure adequate supplies to the Class 1 market. It's our understanding that these commitments were made at a time when it was thought the Class 1 market would continue to expand in California and the cost of the transportation system seemed rather trivial, a situation that has not played out. Our board has supported justified increases to transportation allowances. However, support for such increases is dwindling. Producers see the following situation:

First, overall Class 1 pounds utilized in the pool have remained fairly static, except for the loss of out-of-state Class 1 usage.

At the same time, the cost of transportation incentive system has increased an average of 13 percent per year.

In a review of hearing outcomes dated back to March 1993, our findings show that the Class 1 price has been increased only one time, in 1993, but has been reduced four times.

We have already discussed the third justification that consumers are less sensitive to changes in the price of fluid milk than they are to changes in cheese prices.

Because declining Class 1 percent utilization of the pool and per-capita consumption of fluid milk products have been cited as justification for maintaining low Class 1 prices in California, we need to examine this data a little more fully.

In the last Hearing Panel report, CDFA noted that per-capita consumption calculations submitted into the hearing record were based on incomplete or partial data. To accurately reflect Class 1 per capita consumption, the following data must be included:

First, packaged Class 1 products sent directly to wholesale and retail customers in California, coming from sources other than California plants. Packaged product from other states is sold in California. Exactly how much and its origin is simply unknown.

2. California packaged products sold outside of California. California packaged products are sold outside of California. This is confirmed with data obtained from the Nevada Dairy Commission. And I've attached that as Appendix B. Though we will discuss this data in greater detail later, we should mention that our analysis of the data shows that packaged shipments from California to Nevada were equal in amount to nearly 2 percent of the total Class 1 sales in California during the second

quarter of 2006. This means that if these sales were included in Class 1 sales for California, sales figures would increase an additional 2 percent for the second quarter of 2006. This would be on top of the increases witnessed to date so far for Class 1 sales this year.

Because Class 1 sales data is incomplete, it should not be used as a determination in setting the appropriate Class 1 price in California.

On a somewhat similar note, we question the use of Class 1 as a percentage of the total California pool, or a percent utilization, as an indicator of Class 1 consumption. This figure gives a false sense of actual consumption because the Class 1 utilization as a percentage of the pool is reduced due to faster growing usage in other classes.

An additional factor in the large drop is the fact that out-of-state milk is no longer included in the California pool utilization figures and a large percentage of this milk is used for Class 1. When other source and exempt producer-distributor milk is added back in, Class 1 utilization remains relatively static year to year, registering both increases and decreases. Data for Class 1 utilization through August 2006 shows nearly a 1 percent increase in total pounds utilized as Class 1 in California for the year to date.

Section 61805(b): In determining minimum prices paid to producers, the director shall endeavor under like conditions to achieve uniformity of cost to handlers.

Uniform costs to handlers within marketing areas have been achieved with the announced minimum Class 1 prices for northern and southern California. The advantage provided to producer-distributors due to the their Class 1 exemptions is a concern historically raised at Class 1 hearings. We do not disagree that this advantage exists. According to CDFA data, producer-handler share in Class 1 sales decreased slightly from 2004 to 2005, representing about 19.17 in 2004 and 18.98 percent in 2005. Their share is up slightly through September of 2006 at 19.5 percent.

However, we do point out that their advantage is limited given the level of their exemption is static and they are required to compete at the same price level with the remainder of their production which is the bulk, around 80 percent, of their sales.

We do not believe the Class 1 price increase proposed will have any significant impact on the current competitive situation between PDs and other processors as the proposed increase will be felt by the PDs on the majority of their sales. On their exempt amount, our proposed increase is minuscule when compared to the total exemption they already enjoy. The only way to establish a uniform price with PDs would be to eliminate their exemption entirely.

Section 62062.1 was already read by the Alliance.

A great deal of time has been spent on accurately defining the Legislature's intent through the use of the term "reasonable" when setting the appropriate Class 1 price in relationship to surrounding areas. We offer that "reasonable" should be viewed as a price that allows California processors to be competitive, but at the same time provides a fair return to producers.

A comparison of the California statewide Class 1 price to those in surrounding areas is below.

Our assessment shows that California processors are competitive and will continue to be if our proposal is adopted.

We should note the following comparison of California's Class 1 butterfat price to those surrounding areas to explain our 2-cent-per-pound reduction in the Class 1 fat price.

We recognize that many factors are at play when assessing the competitiveness of California's Class 1 processors. In particular, a comparison of Class 1 prices between competitive markets is merited. Regional differences within the state and the unique competitive relationships that exist warrant an individual discussion of each area.

Relationship with Nevada.

California Class 1 processors have proven their ability to be competitive in nearby out-of-state markets. Data obtained by the Nevada State Dairy Commission reveals that California comprises a growing percentage of the Class 1 packaged sales in Nevada. Over 3.4 million gallons of packaged Class 1 product was shipped from California to Nevada in the second quarter of 2006. This figure's up nearly 30.5 percent over the same quarter in 2005.

The reality is that California's Class 1 processors are also supplying nearby markets, and the demand in those markets has grown dramatically. Despite the existence of local fluid plants in Nevada, California has captured a meaningful market share. Conversations with the Nevada Dairy Commission suggest that California's packaged products shipped to Nevada now comprises approximately 20 percent of Nevada's Class 1 sales.

A review of the Nevada markets show that an increase in California's Class 1 price will not hamper our ability to compete with fluid processors in that state. Only one fluid processor is located in northern Nevada. Apparently most of the states' 32 dairy producers ship to this plant. It is also our understanding that this plant has a history of fluid shipments into the Tahoe region, shipments that have been at a consistent level, and they are based on location advantages and long-term relationships. Finally, the northern Nevada Class 1 price is set equal to the northern California Class 1 price.

In 2006, the southern Nevada Class 1 price trailed the southern California Class 1 price by 2 cents per hundredweight. Two fluid processors are located in southern Nevada. It is our understanding that Anderson Dairy sources all their milk from Utah and some from California, and that condensed product is shipped to California from this plant.

The second plant is Meadow Gold. According to the Nevada Dairy Commission, approximately 30 percent of the milk used by the Meadow Gold fluid plant in Las Vegas is supplied by California sources.

Las Vegas is a rapidly growing market in terms of demand. However, a local milk supply no longer exists. In fact, we understand only one large load per day is supplied to this plant from northern Nevada. The plant is closer in proximity to California sources. It's our understanding that the Las Vegas plant was built with the purpose of primarily serving the Las Vegas market. It seems highly unlikely that this plant will compete with

California processors for the California market. The increasing shipments of packaged product from California to Nevada supports this assumption.

The passage of the Milk Regulatory Equity Act has also resulted in elimination of compensatory payments paid by California processors on their shipments to the Las Vegas area. This has afforded California processors an additional competitive edge over local suppliers serving these markets.

Finally, California processors are supplying Starbucks fluid needs, as we understand, for over 90 stores in the Las Vegas market. The Class 1 price increase we are seeking should not change this dynamic, as the other potential suppliers are limited in their abilities to serve this exploding market. The Arizona Class 1 price, the other location from which Safeway supplies Starbucks, as we understand, is much higher.

Relationship with Oregon:

At the last hearing, Crystal Cream and Butter suggested that competition from out-of-state fluid processors has dwindled from the aggressive levels noted in the past. Crystal noted that the major reason for a reduction in competition is a lower Class 1 prices in northern California when compared to neighboring, specifically Oregon, states.

WUD's proposal would not change the situation outlined by Crystal. In 2006 the Medford, Oregon, Class 1 price averaged 75 cents per hundredweight above the northern California Class 1 price. With our proposal in place, northern California processors would still enjoy a 31-cent-per-hundredweight advantage.

Again, we realize there may be differing interpretations of the code. But we believe that ours most clearly follows the intent of the enabling legislation. We urge the implementation of our proposed increase to the Class 1 price.

The Dairy Institute alternative proposal:

WUD has requested specific changes to the Class 1 minimum pricing formulas that we are testifying in support of today. For that reason, we do not support the alternative proposal put forth by the Dairy Institute. We are, however, appreciative of the fact that in the most recent two years their proposed changes would have resulted in increased Class 1 prices. Obviously, the price enhancements in their proposal is due solely to the recently strong dry whey markets. Whether this trend over the last two years will continue is unknown. Because of the negative differential to the CRP, a drop in dry whey prices could lead to a significant reduction in the Class 1 price, which is contrary to the outcome we are proposing.

The petition put forth by the Alliance is very similar to that we proposed. We therefore support the arguments put forth today by them.

We thank you for the opportunity to testify and respectfully request the opportunity to file a post-hearing brief.

HEARING OFFICER AYNES: If a post -- if there is a post-hearing brief period, you may file a post-hearing brief.

Are there questions from the Panel?

AGRICULTURAL ECONOMIST GOSSARD: Yes, I have several questions.

On page 1 of your testimony -- this is just a small point -- you mentioned your directors in April approved your position, which would have been your original petition.

Did the directors also approve the testimony you presented today?

MS. LaMENDOLA: Yeah. We've since discussed it at subsequent board meetings. That was just at the board meeting which they -- before we filed the petition.

AGRICULTURAL ECONOMIST GOSSARD: On page 3, you show a decrease in bulk milk entering California between 2005 and 2006.

Could this possibly be due to the relative lowering of the Class 1 price to out-of-state prices? That the lower prices that we're experiencing now is a cause of this decrease in bulk milk coming in?

MS. LaMENDOLA: It could be. I'm sure it's likely a factor. But that's why we spent so much time trying to understand the markets from which we receive the bulk milk. And I think in focusing on that, it's hard to ascertain exactly where the increases or decreases are coming from. There was an increase over 2004 levels. It seems to be a bit hard to explain, especially in regards to Nevada.

AGRICULTURAL ECONOMIST GOSSARD: On page 15 of your testimony, you state that -- at the top, that the Class 1 -- the percent that Class 1 forms the pool was not a good measure of a Class 1 market because it's -- with the growth of 4a, 4b, it just will always be decreasing.

The pooling price letter, which is a document for this hearing, includes percentages. Would you want those percentages removed from the price letter?

MS. LaMENDOLA: Well, no, I'm not -- I'm not recommending that. I think I just would rather see that total utilization figures on a pounds basis is looked at. In many of the results from the Hearing Panel, we see that, you know, percent utilization figures have declined rapidly, and it's used a lot. However, looking at total pounds isn't always indicated along with that. So that's just a point we were trying to highlight.

No, I'd use a percent utilization in trying to calculate prices each month.

AGRICULTURAL ECONOMIST GOSSARD: Finally, at the top of page 18, you say, "Apparently, most of the states' 32 dairy producers ship to this plant," referring to Model plant.

Doesn't a fair quantity of milk come into northern California from these dairy farmers as well?

MS. LaMENDOLA: Yeah, I think that's where most of the milk from Nevada comes into California, from -- it's my understanding, from our meeting with the Nevada Dairy Commission.

AGRICULTURAL ECONOMIST GOSSARD: No further questions. Thank you.

HEARING OFFICER AYNES: Are there further Panel questions?

Hearing none.

Thank you for your testimony.

The Dairy Institute will now receive 30 minutes to present its alternate proposal.

Would you state your name and spell your last name for the record please.

DR. SCHIEK: Yes. My name is William Schiek. That's S-c-h-i-e-k.

(Thereupon Dr. Schiek was sworn, by the Hearing Officer, to tell the truth, the whole truth and nothing but the truth.)

DR. SCHIEK: I do.

HEARING OFFICER AYNES: Do you wish to submit this document as an exhibit?

DR. SCHIEK: I do.

HEARING OFFICER AYNES: This will be Exhibit No. 49.

(Thereupon the above-referenced document was marked, by the Hearing Officer, as Exhibit 49.)

HEARING OFFICER AYNES: You may proceed with your testimony.

DR. SCHIEK: Thank you.

Mr. Hearing officer and members of the Hearing Panel. My name is William Schiek and I'm the economist for Dairy Institute of California. And I'm testifying on the Institute's behalf.

Dairy Institute is a trade association representing 40 dairy companies which process approximately 75 percent of the fluid milk, cultured, and frozen dairy products, over 60 percent of the cheese products, and a small, very small percentage of the butter and nonfat milk powder processed and manufactured in the State. Member firms operate in both marketing areas in the state. And the position presented at this hearing was adopted by Dairy Institute's Board of Directors.

Dairy Institute appreciates the opportunity to testify at this hearing in support of our alternative to adjust California's formula for setting Class 1 prices. We'd also thank the Department for the opportunity to comment on the petitions submitted by the Alliance of Western Milk Producers and Western United Dairymen, which are also under consideration at this hearing.

At issue in this hearing are proposed changes to the pricing formulas for Class 1. In establishing pricing formulas, the Secretary is directed by the Legislature to weigh the factors found within the statute. The California Legislature has declared that milk production and marketing is a business affected with a public interest. Therefore, the dairy programs must be operated so that the public interest is served.

The public interest extends well beyond the consideration of producer interest exclusively and also includes the interests of processors, retailers, distributors, and consumers.

The Legislature states also that it is the policy of the state to promote, foster, and encourage the intelligent production and orderly marketing of market milk and to eliminate economic waste, destructive trade practices, and improper accounting for market milk.

The Legislature has declared that prices established by CDFA must allow for prices to producers and consumers that are fair and reasonable. In addition, the Secretary must consider how the pricing formulas provide for uniform milk prices to handlers operating within the marketing areas. Also, the combined producer revenue from all milk classes must be sufficient so as to result in an adequate supply of milk for all purposes, including manufacturing purposes, which is vital to the public health and welfare.

With regard to class prices, the Legislature requires that the Secretary consider milk production costs in setting such prices. The Secretary has been directed by the Legislature to ensure that Class 1 prices are in a reasonable relationship to Class 1 prices in surrounding states, and that prices for market must bear a reasonable and sound economic relationship to each other.

The Secretary is also directed to conform the pricing standards governing minimum producer prices for market milk to current economic conditions and to consider any other relevant economic factors in setting milk prices that are not explicitly set forth in the code.

The Secretary must consider how to set prices and pricing formulas such that all of the declared intentions of the Legislature are met as closely as possible. In so doing, the Department must look beyond the confines of any single section of the code. When all relevant economic factors are considered in tandem with the specific legislative directives regarding milk pricing, it is evident that the current stabilization and marketing plans for market milk no longer provide for Class 1 prices that conform with these directives; and therefore, the plans must be changed.

We testified at length as to the failures of the existing stabilization and marketing plans at Class 1 hearings held on May 3rd and May 6th, 2005. We refer the Panel to that testimony, which is contained in Hearing Exhibit No. 43, for the details of those arguments. But the failures of the current plan chiefly stem from the fact that the level of Class 1 prices are too high relative to the manufacturing classes of milk in the state and relative to those in surrounding states. Increasing the overall Class 1 price level as the petitioners have suggested would only worsen the failure of existing plans to meet statutory mandates.

Another problem with the existing formula is that it does not track the movements of Class 1 prices in contiguous states as well as it could. In light of the requirements of Section 62062.1 of the California Food and Ag Code, some changes to the formula beyond a simple adjustment to the overall price level appear to be warranted.

Dairy Institute's proposal would reduce the overall Class 1 price level in both northern and southern California, and in so doing would bring the current plans more in line with the requirements and guidelines set forth by the Legislature. However, under certain market conditions, our proposal would result in higher Class 1 prices than does the current formula. This occurs because of the second major feature of our formula, namely, the addition of a dry whey factor to the Commodity Reference Price calculation for cheese. Our proposed Class 1 formula is relative straight-forward and is shown below.

And the changes to the current formula are highlighted. Obviously, in the Commodity Reference Price on a cheese calculation, we're adding the advance dry whey price times a yield of 5.8 less an adjustment factor of 85 cents per hundredweight.

We're also including an adjustment to the calculation of Class 1 fat by reducing -- or increasing the butterfat adjuster to 11.8 cents. And we're reducing the CRP adjuster from its current level of plus 46.4 cents to a new level of minus 17 cents.

Dairy Institute is proposing the addition of a dry whey factor into the cheese-whey cream portion of the Commodity Reference Price calculation to improve the tracking of California Class 1 prices with those in surrounding states, which are driven by federal order pricing formulas.

The federal formulas currently include a dry whey factor and California formulas currently do not. In recent years dry whey prices have become quite volatile, and the disparity between the California and federal formulas has created a disconnect between the Class 1 price movements in California compared to those in surrounding states. Our proposed adjustment will result in better alignment of prices through time and over a broader range of dairy commodity market prices.

Dairy institute is also proposing a change to the formula known as the CRP adjuster. Currently the adjuster has a value of plus forty-six four in the formulas that compute the component prices for Class 1 solids not fat and Class 1 fluid carrier. We advocate changing the adjuster to a new value of minus 17 both as a means of accommodating the addition of the dry whey factor to the CRP calculation and to establish an appropriate level for

California's Class 1 price differential given the state's status of being the regulated dairy market with the nation's lowest Class 1 utilization percentage.

In developing the proposed, Dairy Institute was concerned chiefly with two main factors. First, the proposed formula should do a better job than does the current formula in tracking federal order Class 1 price movements. Second, the proposed formula should reflect an overall price level that is appropriate given California's market structure, i.e., the low Class 1 utilization percentage, and its competitive position with regard to out-of-state milk supplies.

The proposed formula was thus developed in two steps. The first step involved making formula adjustments for better tracking of other states' prices. This was chiefly accomplished by the inclusion of a dry whey factor. But some changes to the CRP adjuster were necessary to achieve the same overall price level in relation to surrounding states as is generated by the current formula.

In adding the dry whey factor to the CRP, Dairy Institute is not making any argument regarding the appropriateness of dry whey as a component in the Class 4b formula. Rather the addition of dry whey is simply a device to improve the tracking of California and the surrounding states' Class 1 prices.

The second step of our proposal involved making a parallel adjustment to the formula so that it would continue to track federal order prices, but the overall price level would be consistent with economic principles, the structure of California's market, and the competitive conditions facing the state's Class 1 processors.

Another change that we proposed is shifting some of the Class 1 value from fat back to skim to bring California fat prices into better alignment with surrounding states.

Our proposal is in agreement with the Alliance proposal on this point. At previous hearings we had argued for a higher fat price and a lower skim price relative to federal orders as a means of helping California-standard milks face less of a competitive disadvantage when they were marketed in surrounding states. It is our understanding that the majority of California-processed milk that is sold outside California today is processed to federal standards, so there is less of a reason for the current skim/fat value tilt to be maintained.

The tables below compare California's Class 1 prices to those in surrounding states for the current formula and the two steps just described above. A little explanation regarding these numbers is warranted. The data shown are generated by subtracting the relevant California average Class 1 price, from January -- that should be 2000, not 2001 -- January 2000 through November 2006 -- from the relevant average price in contiguous states. If the value is negative, it means that the other state's price is lower than the California price. If the value is -- the number is positive, it means that the other state's price is higher than the California price.

Panel members will note that the per hundredweight price relationships generated by the current formula and the first step of our proposal development are nearly identical. The average per hundredweight price level after the final step of our proposal development is about 35 cents per hundredweight lower than the average prices generated by the current formula over that period.

Dairy Institute is thus proposing a reduction in the overall average price level of about 35 cents per hundredweight. The basis for this reduction is a model relating Class 1 utilization percentage to the Class 1 differential in the market. The economic basis for a price differential between Class 1 prices and manufacturing milk prices is to ensure that there are adequate supplies of milk for fluid use plus an adequate reserve. In markets where Class 1 utilization as a percentage of the total supply is low, there is less of an economic justification for high Class 1 price relative to manufacturing milk prices. The Class 1 differentials employed in federal order markets generally reflect this principle.

Table 2 is a description of Class 1 differentials and Class 1 utilization for 2006.

And I note one difference there. The Western order was terminated. And that data that's presented for the Western order reflects the utilization average from 2000 through 2004 up to the point where its terminated.

The Class 1 differentials in federal orders can be plotted against market utilization and a mathematical relationship can be determined. This relationship can be used to calculate the appropriate Class 1 differential in California given the state's Class 1 utilization. The models suggests a Class 1 differential reduction of about 35 cents her hundredweight in California is appropriate.

The Class 1 differentials in California and the federal orders are plotted in Figure 1 against the Class 1 utilization percentage for the first nine months of 2006. A linear relationship has been estimated and a predicted value for California can be calculated. The predicted differential value is then compared to the calculated differential's actual Class 1 differential in the state.

And Figure 1 shows that plotting and the equation estimated.

Class 1 differentials in the federal orders which governs surrounding states' prices are calculated as the difference between the Class 1 price and the Class 1 mover for a given month. The Class 1 mover is simply the higher of a Class 3 or Class 4 price calculation evaluated using the federal order advance pricing factors. To come up with an equivalent comparison for California it is necessary to create a modified Commodity Reference Price using California's Class 4a and 4b pricing formulas inclusive of make allowances, product yields, and f.o.b. adjusters. The modified CRP is calculated by employing the same commodity price averages used for California's Class 1 price computations. By comparing the modified CRP to the Class 1 price, a California Class 1 differential that is equivalent to Class 1 differentials in federal orders can be calculated. Using this method, we determined that the average California differential from January 2000 to November 2006 was $2.02 per hundredweight for northern California and 2.29 for southern California, or a simple average for the state of about 2.15 per hundredweight.

It is important to note at this point that employing a different differential calculation method such as subtracting the federal Class 1 mover from California Class 1 prices is not appropriate because it takes no account of California's manufacturing class prices and is therefore not equivalent to a federal order differential.

Based on the model described above in Figure 1, the appropriate differential given California's 2001 Class 1 utilization of 14.3 percent is approximately a dollar eighty per hundredweight, 35 cents lower than current. In other words, to be consistent with economic principles employed in the establishment of Class 1 prices in surrounding states, California's overall Class 1 price should be about 35 cents lower than the average price level generated by the current formula. A reasonable relationship with Class 1 prices in contiguous states would thus be one that is consistent with the arguments we have been -- we have presented above and with our alternative proposal.

The graphs on the following pages show the relationship between California and federal prices under the current formula and the Dairy Institute proposal. While there may be an argument among industry participants as to whether a reasonable relationship requires higher, lower, or identical prices with those in surrounding states, we believe that most would agree that a formula that tracks federal order movements more consistently is more reasonable than one which tracks poorly.

Looking at Figure 2, you can see how -- just some explanation here. The California price in this graph is represented by the zero axis line. In other words, if the federal price were identical to the California price, the graph line would lie right along the zero axis.

But what you see is that sometimes California prices are closer to the Phoenix price, as -- or the Arizona price, as was the case from January 2000 to about the middle of 2003. But then in other times it's much closer to the Las Vegas price, as in from about 2004 forward.

If you look at what we did in Figure 3, which was sort of the intermediate step in developing our proposal, we tried to achieve the same overall average price level over the 2000 through 2006 period, but with a formula that provides a more consistent relationship through time.

Now, commenting on some of Mr. Tillison's comments. He is right in that the NASS CME lag creates some of the problems we have tracking on a month-to-month basis. But -- and I do sometimes see things differently than Mr. Tillison. But as I compare Figure 2 to Figure 3, it really looks to me like Figure 3 creates a more consistent relationship between California and federal prices through time. At least the mean sort of body of that -- of those price relationships, it appears to be more consistent through time than the current formula.

Figure 4 is the ultimate sort of step in Dairy Institute's proposal; and essentially is the same thing as Figure 3, except the Class 1 prices in California adjusted downward by 35 cents per hundredweight.

And Figure 5 is the same relationship estimated for Portland over time.

Okay. Current Class 1 prices are not in a reasonable relationship to prices in surrounding states. We have argued at past hearings that the term "reasonable relationship" does not mean prices that are equal to those in other states. The only objective legislative history available on Section 62062.1 is the history of amendments made to the bill that resulted in this section of code being implemented. In early versions of the bill, producers had attempted to insert language that would have set California prices at a level 10 cents per hundredweight less than the six-month average of prices received in surrounding states. This language was ultimately rejected by the Legislature and the term "reasonable relationship" to prices in surrounding states was adopted instead.

If the Legislature had met for the term "reasonable relationship" to mean equal Class 1 prices, it clearly had an opportunity to adopt specific language to that effect. However, it explicitly chose to reject such language in favor of the term "reasonable relationship." Therefore, the Legislature clearly did not mean that the term "reasonable relationship" should be interpreted in all cases and at all times to mean equal prices.

In the absence of specific legislative history defining what a reasonable relationship might be, courts refer to the plain meaning of the statute. The most applicable and pertinent dictionary definition for "reasonable" is "agreeable to reason." Not particularly helpful.

But the word "reason" is defined as: a) a statement offered in explanation or justification; b) a rational ground or motive; or c) a sufficient ground of explanation or of logical defense that supports a conclusion.

Thus a reasonable relationship between Class 1 prices in California and those in contiguous states is one for which there is sufficient ground of explanation or a logical defense. One such logical defense is a price relationship that is in agreement with other statutes that govern milk prices. Another is a price relationship that is supported by the economic principles of milk marketing and by sound public policy goals.

A reasonable relationship with regard to California milk prices thus takes into account the differences in the structure of the markets in different states, the differences in the competitive environments between regions, and other relevant economic factors.

And I refer you to Appendix Table A1, which is attached to the back of the testimony, which is an update of the table that was in our testimony in 2005. It shows Class 1 utilizations in the various regions, the Class 1 differentials, as well as USDA's cost of production estimates, as well as some costs data that came from Genske and Mulder that was published in Hoard's Dairyman man in 2005.

That data is then changed to an ordinal ranking. And what you see is that California ranks at the bottom of with regard to Class 1 utilization and with regard to costs of production. Yet its Class 1 differential is more in the middle of the pack rather than toward the bottom where we believe economic principles say that it should be.

Okay. In short, given the current market structure in California and in surrounding states, which we have explained in detail during our testimony here today, a reasonable relationship is one where the California Class 1 price differential is lower than it is in other markets where Class 1 utilization is higher. Therefore, the Dairy Institute proposal is one which generates prices that are in reasonable relationship to Class 1 prices in contiguous states. The petitioners' proposals do not.

The Secretary is directed to consider other relevant economic factors in establishing Class 1 prices. The economic incentives in the marketplace cannot be ignored. Currently, packaged milk, though now regulated, is still moving into southern California. Other economic incentives exist that would allow processors the opportunity to procure raw milk supplies by alternative means from inside and outside of the state at a net cost that is below the regulated Cost 1 price. Members of Dairy Institute will present more information on these issues later in this hearing. It is not sound economic policy to establish minimum prices at levels that discourage the use of the closest milk in serving the state's Class 1 market. The overall Class 1 price level should be lowered so that nearby California milk could be used to supply local markets. This change would be an economically efficient policy and would promote more orderly and intelligent production and marketing of milk as directed by the Legislature and would discourage economic waste of needlessly trucking milk around.

The Department noted the following in its Statement of Determination stemming from the February 1997 Stabilization and Marketing Plan hearings:

"Given the legislative declarations that it is not in the public interest to promote or encourage economic waste or inefficient marketing of milk, and that California has a plentiful supply of milk produced at the lowest cost in the nation, it is appropriate to question what public interest is being served by creating artificial high price signals which encourage milk shipments into California in both bulk and packaged form."

We concur with the Department that the public interest is not served when economic incentives exist within the regulated market pricing system that cause, directly or indirectly, inefficient and disorderly movements of milk. To eliminate such incentives for economic waste, the California Class 1 price differentials should be reduced as we have proposed.

From a common sense level, one has to question the logic of trying to increase producer revenues by increasing Class 1 prices. Perhaps such a strategy made sense when Class 1 usage amounted to a more significant portion of the pool. But Class 1 utilization has run a distant third to Class 4b and 4a for many years now. At today's usage, a $1 per hundredweight increase in Class --

excuse me -- in a Class 1 price, that should say, would increase pool prices by only 14.3 cents. At the same time, the dollar per hundredweight increase would have two impacts. It would drive up retail prices for fluid milk. And, yes, there is still a strong correlation between Class 1 price increases and increases in retail fluid milk prices. And it would create a bigger incentive for milk to be shipped in from outside California.

High Class 1 prices in California make an attractive market for producers in nearby states who are facing significantly lower average prices for their milk.

For example, Arizona milk production has grown by 167 million pounds her year since 2001 and it shows no real signs of slowing. We have typically calculated the incentive to ship milk from Arizona as the southern California Class 1 price less the Arizona blend. But in many cases the local price facing an Arizona producer is less than the blend. First, producers must pay a local haul. Second, access to the local market is far from guaranteed. New producers find that the co-op operating the state maintains something like a quota and overbase system, so that the price facing a producer is often substantially less than the announced market blend price. Increasing the California Class 1 price will draw this milk westward, supplanting California milk in the market.

The consumer response to higher Class 1 prices is hard to separate from all of the other impacts in the marketplace, but one thing is clear: Consumers are consuming less California-sourced Class 1 milk, both in absolute terms and on a per capita basis. At one point California consumers drank more milk than consumers in the rest of the country on a per capita basis. I refer you to Figure 6.

This high per capita consumption corresponded to a time when Class 1 prices were relatively low in relation to surrounding states' prices and relative to prices of the manufacturing classes.

After quota reform and the elimination of the old three-factor formula, Class 1 prices increased substantially and fluid milk consumption appears to have responded negatively. Figure 7 shows the California beverage milk sales from 1990 to 2005.

And these data come from the reported CDFA numbers. And, granted, there are some things missing in there. But I think what we're saying is that the milk supplied to the California market by California producers and processors is relevant. That's the relevant share.

Uniform prices to handlers:

The current plans fail to foster uniform prices to processors competing in a marketing area. Exempt producer-distributors have an advantage in the marketplace because they incur no pool obligation on their exempt quota holdings. The advantage is usually calculated as the difference between the Class 1 price and the quota price. Thus, the higher the regulated Class 1 price is relative to manufacturing class prices, the higher will be the P-D advantage on his or her milk shown in the figures below. And I'm going to skip through the rest of that. But I would like you all to take a look at it.

Basically the advantage of the P-Ds will increase any time Class 1 prices increase, because the exempt portion is sort of -- their blended advantage out over their whole production increases when Class 1 price increases. And the two charts basically show that there's a positive relationship between the P-D advantage and the Class 1 price and that the P-D advantage has averaged on a per hundredweight basis close to a dollar per hundredweight for several years now.

With regard to other proposals, we oppose the proposals of the petitioners, Western United Dairymen and the Alliance of Western Milk Producers. Both proposals would increase the overall Class 1 price differentials, and we have argued that a decrease is warranted by economic principles and by competitive conditions in the marketplace. If either the Alliance or Western United proposal is adopted and whey prices decline from their current record-high levels, California processors will be facing higher prices and facing competitors in contiguous states that have lower regulated prices, putting them at a disadvantage, and increasing the share of California's Class 1 market held by out-of-state suppliers.

Also, both petitioners' proposals do nothing to improve the tracking of California's prices with prices in contiguous states.

Dairy Institute's proposal would make California's Class 1 price relationship with contiguous states more consistent through time and would better meet the requirements of Section 62062.1.

In the past, petitioners have suggested that the widening spread between farm-gate and retail prices suggests excessive profits are being made in the processing or retailing sector and that this is evidence of dairymen failing to receive their fair share of the retail dollar. While the nominal price spread has grown over time, this is more likely evidence that the cost of the post-farm-gate marketing of milk are rising faster than the cost of milk production at the farm.

There has also been some suggestion in the industry that California's Class 1 utilization is not really as low as it seems, and that when exempt producer handler milk and other source milk are included, Class 1 utilization is substantially higher.

These arguments are offered as justification for increasing regulated prices. Our point is that when considering pricing policy, it is only the Class 1 pool utilization that is relevant. Increasing the overall Class 1 price levels will increase the incentive to import milk and will increase the advantages associated with the P-D exemption. It should be little comfort to California's producers to know that total Class 1 consumption in the state is holding up, while the share of it that they supply and benefit from is shrinking.

HEARING OFFICER AYNES: Excuse me. You have two more minutes.

DR. SCHIEK: Okay. Petitioners may suggest that the higher milk production costs and low milk prices facing producers today are sufficient justification for an increase in the overall Class 1 price level. We point out that high feed prices and low milk prices are transitory events. Low milk prices are due to the low dairy commodity prices that result from an oversupply of milk in the national marketplace. Low prices have a way of correcting themselves as they lead to contractions in the nation's milk supply and, later, increased milk prices. These price cycles are simply the market working to equate supply and demand. When changes are made to the regulatory pricing formulas to address a transitory phenomenon, the state's competitive condition can suffer permanent damage. And there is no guarantee that when market prices rebound, pricing formulas will be readjusted to restore the competitive balance in the marketplace. In the meantime substantial business can be lost by California's Class 1 processors.

We point out that under market conditions where whey prices are quite high, as they are today, Dairy Institute's proposal actually results in higher Class 1 prices and pool revenues than the proposed formulas of the petitioners. For example, Dairy Institute's proposal would result in Class 1 prices that were 32 cents per hundredweight higher than the Western United proposal and 37 cents higher than the Alliance proposal. In months such as this one, it's important to note that prices in the contiguous states will be substantially higher as well, so that even though if California Class 1 prices increase under the Dairy Institute's proposal, the competitive position is not compromised. When market conditions change and the prices in contiguous states fall, Class 1 prices in California will likewise fall under our proposal. The matching of price movements is less certain under the petitioners' proposals.

If the Department's interested in providing some short-term relief for producers while maintaining the overall competitiveness of California's Class 1 industry, the Dairy Institute proposal would appear to be the better choice. In all likelihood, dry whey prices will eventually retreat from their current high levels. But in the meantime, high whey prices will put more revenue in the pool under the Dairy Institute proposal. And we caution the Department against adopting the dry whey portion of our proposal and combining it with the petitioners' proposals for the CRP adjuster. Such a policy would greatly enhance Class 1 prices and it would make California processors uncompetitive in the marketplace. It would be a disaster for the industry.

HEARING OFFICER AYNES: Thank you for your testimony.

Do we have panel questions?

ASSOCIATE AGRICULTURAL ECONOMIST BORISS: Yes.

DR. SCHIEK: Oh, do you have a --

ASSOCIATE AGRICULTURAL ECONOMIST BORISS: What?

DR. SCHIEK: I was going to -- I thought you were having trouble with your microphone.

ASSOCIATE AGRICULTURAL ECONOMIST BORISS: Oh, I think I got it now.

Okay. Did you consider just adopting the federal price -- or the federal pricing formulas instead of doing a dry whey only? And if so, why?

DR. SCHIEK: No. We did briefly talk about the idea of putting make allowances into the CRP. And the reason for doing that would be that it would maintain a more consistent price relationship among the classes. That is, when make allowances are changed, Class 1 prices are changed. And so if you believe that you get an economic relationship between the classes, that is maintained when you have make allowances in there.

But, you know, we proposed that actually at a hearing in 1999, and it was not well received by either the Panel or by the producers. And so we did not elect to go that route. Plus it made a major change in the formula.

We feel like this one improves the tracking, while making a more simple change to the formula.

And I also would point out that the 85 cents is not a make allowance. It doesn't match any make allowances. And it would not change when make allowances in the manufacturing formulas change. And also it would equate to maybe a 14 1/2 cents whey price. And in the last ten years there have been very few months when the dry whey price was below 14 cents. A couple maybe.

ASSOCIATE AGRICULTURAL ECONOMIST BORISS: And how did you arrive at that .850? Was that part of the --

DR. SCHIEK: Yeah, it was -- I mean 85 cents was arrived at primarily as a means of trying to -- when we were developing that second step that I showed a graph of where we were trying to mimic the same overall average price as a current formula through the 2000 to 2006 period, 85 cents was -- all I could say is it was the number that worked. It was the number that achieved the best balance between, you know, the increase that you get when you add dry whey into the CRP and with the current price level. If you just throw dry whey in, obviously it will increase the Class 1 price much more than our members feel is justified.

ASSOCIATE AGRICULTURAL ECONOMIST BORISS: And my second question: The utilization on the federal orders, did you include depooled milk in that? And would that change your numbers at all?

DR. SCHIEK: Yeah, let me find the table really quickly and I'll talk a little bit about that.

ASSOCIATE AGRICULTURAL ECONOMIST BORISS: Oh, it's in the appendix.

DR. SCHIEK: Yeah, this -- the numbers here do not include depooled milk in the utilization percentages for 2000 -- well, yeah, they don't -- they don't include Class 1 milk that is depooled. And when you look across the whole period, the average utilization does bounce around a little bit because of pooling and depooling.

But the numbers given here are not particularly different from the average in the federal orders. For example, if you look at the upper midwest quarter, the average over the years of pooling and depooling, utilization is actually higher than it was in 2006. That's probably because most of the milk in 2006 is in the pool rather than being depooled.

So I would say that, especially given some of the changes that have taken place in the pooling requirements and the price incentives, that this 2006 numbers don't represent a lot of depooled milk.

ASSOCIATE AGRICULTURAL ECONOMIST BORISS: Okay.

HEARING OFFICER AYNES: Are there further questions from the panel?

AGRICULTURAL ECONOMIST GOSSARD: Again turning to your Appendix Table A1, you show Class 1 differentials, which are fixed for federal orders, and then the equivalent for California up to 15. What time period was that calculated for?

DR. SCHIEK: That one is calculated based on -- I believe I said earlier it was 2000 through November 2006. January 2000 through November 2006.

AGRICULTURAL ECONOMIST GOSSARD: Okay. And then on pages 12 and 13 where you're calculating the P-D advantage as being the difference between the Class 1 price and the quota price; is that correct?

DR. SCHIEK: Um-hmm.

AGRICULTURAL ECONOMIST GOSSARD: Okay. In southern California I assume you used the announced quoted price. In northern California what RQA did you assume?

DR. SCHIEK: Yeah, There's no RQA in the number. So that's strictly the quota price.

AGRICULTURAL ECONOMIST GOSSARD: Shouldn't some RQA be included?

DR. SCHIEK: Well, depending on the -- the RQA probably appropriate -- that where the P-Ds have their ranches would probably be appropriate to include. And assuming the RQA lowers the quota price, that would tend to increase the P-D advantage, if I'm thinking about that correctly.

AGRICULTURAL ECONOMIST GOSSARD: Finally, you didn't complete all your testimony in your oral presentation. But you do want all the testimony in the written document considered?

DR. SCHIEK: Yes, I would.

AGRICULTURAL ECONOMIST GOSSARD: Does that include your request for a post-hearing brief?

DR. SCHIEK: For a post-hearing brief, yes, it does.

AGRICULTURAL ECONOMIST GOSSARD: Thank you.

HEARING OFFICER AYNES: Further panel questions?

DAIRY MARKETING BRANCH CHIEF IKARI: Yes, I just have a couple.

Dr. Schiek, on page 4 where you're talking about the majority of California processed milk is sold at federal standards, is that based on data or anecdotal information?

DR. SCHIEK: Anecdotal from some of our members who at one time were supplying milk into the Las Vegas market at California standard -- California standards. And at some point in the past, 2001, 2002, somewhere in there, I believe they changed and began doing a separate run explicitly for the milk that they were shipping out of state.

DAIRY MARKETING BRANCH CHIEF IKARI: Then on page 6 where you were talking about the difference -- the differential that California should have -- I can't recall but maybe you can, so I'm going to ask the question. When the federal order reform was done, they did a price surface map of every county. How does that number that you came out with compare with that number that the feds had developed?

DR. SCHIEK: You mean the 1-80?

DAIRY MARKETING BRANCH CHIEF IKARI: Yes.

DR. SCHIEK: The one that's a -- the model prediction.

It's pretty close. There's a 2-10 differential for Los Angeles. But you've got to remember that pricing occurs somewhat differently in the federal orders where producers blend price is adjusted based on the plan of first receipt. So in northern California, 1-80 would probably be what most plants would receive. That would be a differential applicable at most plants, based on that price surface.

The other thing that -- of course that differential surface was put into place based on the Cornell model that used data from 1995. And the supply and demand issues have changed substantially since 1995, so those numbers may not be reflective of economic theory anymore even though they may have been at one time.

DAIRY MARKETING BRANCH CHIEF IKARI: Thank you.

HEARING OFFICER AYNES: Any further panel questions?

Thank you for your testimony.

We'll go off the record for a moment here.

(Thereupon a recess was taken.)

HEARING OFFICER AYNES: We're going back on the record.

And we will now be proceeding with public testimony. Members of the public may now testify, with each speaker provided with 20 minutes, followed by questions from the Panel.

To ensure the accuracy of today's hearing record, I request that each witness swear or affirm to tell the truth and nothing but the truth, state your name and spell your last name, identify the organization that you represent, give the number of members in your organization, and state the process by which the organization finalized your testimony today.

First witness will be John Bedrosian.

Would you state your name and spell your last name for the record.

MR. BEDROSIAN: Yes. My name is John Bedrosian. The last name is spelled B, like in boy, E-d-r-o-s-I-a-n.

(Thereupon Mr. Bedrosian was sworn, by the Hearing Officer, to tell the truth, the whole truth and nothing but the truth.)

MR. BEDROSIAN: Yes, I do.

HEARING OFFICER AYNES: And what organization do you represent?

MR. BEDROSIAN: I represent Unified Western Grocers of California.

HEARING OFFICER AYNES: And how many members are in your organization?

MR. BEDROSIAN: There are approximately 560 members?

HEARING OFFICER AYNES: And what process did the organization use to finalize your testimony?

MR. BEDROSIAN: Our senior management.

HEARING OFFICER AYNES: You may proceed with your testimony.

MR. BEDROSIAN: Thank you.

HEARING OFFICER AYNES: Oh, I may as well ask you. Did you want to enter this document --

MR. BEDROSIAN: Yes, I would.

HEARING OFFICER AYNES: -- as an exhibit?

This will be Exhibit No. 50.

(Thereupon the above-referenced document was marked by the Hearing Officer as Exhibit 50.)

HEARING OFFICER AYNES: And you can proceed with your testimony.

MR. BEDROSIAN: Thank you.

Good morning. I am John Bedrosian, Vice President, Manufacturing Division of the Unified Western Grocers. First of all, I want to thank the Secretary and the Hearing Panel for this opportunity to testify and have Unified's comments and opinions considered.

Unified Western Grocers is a retailer-owned grocery wholesale cooperative serving supermarket operators located primarily in the west coast. We sell a wide variety of products typically found in supermarkets. Our members are required to meet minimum purchase requirements. However, they are not required to purchase all their products from their co-op.

Unified started its manufacturing division approximately -- a little over 32 years ago, in September 1974. It consists of a bakery and manufacturers -- excuse me -- a bakery and dairy plants located in Los Angeles, California, primarily serving the southern California marketplace. I have the responsibility of managing our sales and operations of these divisions. Our dairy division processes and distributes fluid milk -- Class 1 only -- a variety of juices, and drinking water.

Since the beginning in 1974, we have purchased all our milk from California produced -- from California producers, and currently purchase all our milk through California Dairies, Inc., CDI.

I am here today in support of Dairy Institute's proposal because it provides an equitable pricing alignment accomplished by tracking federal Class 1 prices that are in surrounding states.

This is extremely important to Unified because it impacts our ability to effectively compete in our marketplace. In recent years we have lost significant business in surrounding states. And even today we can face additional loss of business. Let me explain.

First, the loss of business. In August 2005, we lost a major account, 99-Cent Only markets, to an out-of-state Arizona processor, Sara Farms. This amounted to an annual loss of almost 18 million pounds of milk, or looking at it another way, is a little over 350 tanker loads of fluid milk annually. Now, this of course impacted our CDI partners as well because it created a loss-loss relationship for both Unified and CDI. We lost business, not because Unified or CDI did anything wrong; there were no service issues. It was strictly a price issue.

My second concern is the risk of losing current business. We have several large accounts that operate their own dry and refrigerated warehouses and distribution systems. If they have an opportunity to purchase their dairy products at a lower cost, they can have milk shipped to them directly and then self-distribute. If this came to fruition, it would equate to an annual loss of 90 million pounds of milk. And of course this would have an impact again for both us and CDI. This potential situation would have a severe economic impact on our entire remaining business. We would become less competitive because we would have to support our fixed costs with less volume.

This situation has us very concerned for our short-term and long-term business survival. Dairy Institute's proposal would position us to be competitive in our marketplace.

This ends my testimony. And I'd like to thank again the Panel for listening to our comments and our concerns.

HEARING OFFICER AYNES: Are there any Panel questions?

Thank you for your testimony.

MR. BEDROSIAN: Thank you.

HEARING OFFICER AYNES: The next witness will be Dennis Brimhall.

Would you state your name and spell your last name for the record please.

MR. BRIMHALL: My name is Dennis Brimhall B-r-i-m-h-a-l-l.

(Thereupon Mr. Brimhall was sworn, by the
Hearing Officer, to tell the truth, the
whole truth and nothing but the truth.)

MR. BRIMHALL: Yes.

HEARING OFFICER AYNES: What organization do you represent?

MR. BRIMHALL: Super Store Industries.

HEARING OFFICER AYNES: And how many members are there of that organization?

MR. BRIMHALL: Super Store Industries is owned by two major grocery store chains.

HEARING OFFICER AYNES: Okay. And by what process did the organization finalize your testimony today?

MR. BRIMHALL: Through our Vice President of Dairy operations.

HEARING OFFICER AYNES: And did you wish to submit this document as an exhibit?

MR. BRIMHALL: Yes, please.

HEARING OFFICER AYNES: Your document is Exhibit No. 51.

(Thereupon the above-referenced document was marked by the Hearing Officer as Exhibit 51.)

HEARING OFFICER AYNES: You may proceed with your testimony.

MR. BRIMHALL: Fifty-one?

HEARING OFFICER AYNES: Fifty-one.

MR. BRIMHALL: Mr. Hearing Officer and members of the Hearing Panel. My name is Dennis Brimhall and I'm the controller of our Super Store Industries. Our company has plants in Fairfield and Turlock. We process fluid milk products at our Fairfield plant and milk, cottage cheese, sour cream, yogurt, and ice cream at our Mid Valley Dairy plant in Turlock.

We supply dairy products primarily to the Raley's and Save Mart supermarket chains. I was directed by our Vice President of Dairy Operations to testify as to our company's position at this hearing.

Super Store Industries is a Dairy Institute of California member and we fully support the proposal contained in Dairy Institute's alternative proposal and with the testimony given by its witness, Dr. Schiek. We agree with Dairy Institute that the current California Class 1 price formula should include a dry whey factor to improve tracking of prices with regulated Class 1 prices in surrounding areas.

We also agree with the change in the CRP adjuster to establish the appropriate Class 1 price level that reflects California's low Class 1 utilization.

Dairy institute's testimony provides sufficient justification to modify the Class 1 formula. However, we want the Department to be aware of other factors in the marketplace that indicate an increase in the overall Class 1 price level, as suggested by the petitioners, is not warranted.

From our perspective, competitive pressures at the retail level in northern California are not from sources in either the Pacific Northwest or the federal -- or the Arizona federal milk orders that were referred in other testimonies. Our strongest out-of-state competition is from the western Nevada, or Reno, area. Competing stores in that area receive milk from various sources, including Utah, which is not regulated at all.

Please refer to the attached graph. If you wouldn't mind referring to that graph -- it's on a legal-size paper -- as I read this next paragraph.

Refer to the attached graph which compares the northern California lowest lawful prices -- that's the solid line -- to the western Nevada lowest reported whole milk retail prices -- that's the dashed line -- over the last three years.

Nevada's law is similar to California's in that milk cannot be sold below cost. It is obvious that there are wide fluctuations between prices in these two marketing areas. Please pay particular attention to the annual averages. In 2004 and 2005, northern California average prices per gallon were higher than the milk in western Nevada. Now, 2004 California -- looking at the bottom -- was 2-45 versus western Nevada was 2-41. In

2005, northern California was 2-42 versus western Nevada, which is Reno, was 2-36.

The California price is lower than Nevada in November -- or, excuse me -- through November of 2006. Refer to those numbers as 2-17 in California versus the 2-25 in western Nevada. But just looking at one year, especially when there's -- when there's so much fluctuation, would be irresponsible.

And I want to point out that even though 2006 California is lower, if you notice July and August, Nevada is lower than California. There's a tremendous amount of in these numbers. That's why I think it's -- to look at just one year, to look at just 2006 would be irresponsible because of that fluctuation.

The average price for all three years is, for all practical purposes, the same between the two areas. Numbers on the bottom right-hand side. California averaged over those three years $2.35 a gallon. Nevada -- western Nevada averaged $2.34 a gallon. So only a penny difference per gallon.

Determining the appropriate price for raw milk is a detailed and complicated proposition. But it's just the beginning of the many factors including freight, service charges, various processing costs, packaging and delivery, et cetera, that determine the price consumers pay for packaged milk. To help me put this all into perspective, the data I presented simply shows the lowest retail prices available to consumers in northern California and in Reno, which is the most significant of the northern California surrounding areas.

The point I want to make with this testimony is that the northern California Class 1 price determines retail prices that are already in line with those in the out-of-state area in which we face the strongest competition. We are concerned that the northern California Class 1 price -- that if the northern California Class 1 price increases, as requested by the petitioners, the doors will be opened to encourage the importation of lower cost out-of-state processed milk, thus putting all northern California producers and processors at a competitive disadvantage.

I thank you for this opportunity to testify. I'll try to answer any questions you may have. And I'd also like to have the opportunity to file a post-hearing brief.

HEARING OFFICER AYNES: If there is a post-hearing brief period, you may file a post-hearing brief.

Are there questions from the panel?

Hearing none.

Thank you for your testimony.

MR. BRIMHALL: Thanks.

HEARING OFFICER AYNES: The next witness would be Evan Kinser.

Would you state your name and spell your last name.

MR. KINSER: Evan Kinser K-i-n-s-e-r.

(Thereupon Mr. Kinser was sworn, by the Hearing Officer, to tell the truth, the whole truth and nothing but the truth.)

MR. KINSER: I do.

HEARING OFFICER AYNES: What organization do you represent?

MR. KINSER: Dean Foods Company.

HEARING OFFICER AYNES: And what's the number of members of that organization?

MR. KINSER: We're a single organization.

HEARING OFFICER AYNES: Okay. And by what process did the organization finalize your testimony?

MR. KINSER: It's been approved by management.

HEARING OFFICER AYNES: Did you wish to submit this document as an exhibit?

MR. KINSER: Yes.

HEARING OFFICER AYNES: And then your document will be identified as Exhibit 52.

(Thereupon the above-referenced document
was marked, by the Hearing Officer, as
Exhibit 52.)

HEARING OFFICER AYNES: You may testify.

MR. KINSER: Mr. Hearing Officer and members of the Hearing Panel. My name is Evan Kinser. I am the Director of Dairy Policy and Commodities for Dean Foods Company. Since this is my first time to testify in a California hearing, please allow me to provide you a little background about myself.

I grew up on a dairy farm in southwest Missouri that my family continues to operate. I earned a Bachelor of Science in Animal Science and Agricultural Economics from the University of Missouri - Columbia. While at Mizzou I spent two years working with Ken Bailey on federal order and other dairy issues. I was a research assistant for Dr. Bob Cropp while earning an MBA in Agribusiness at the University of Wisconsin - Madison. I co-authored two risk management studies with Dr. Cropp.

I was a trading assistant for Downes and O'Neill, a Chicago-based dairy brokerage service. I earned my Series 3 brokerage -- Series 3 commodity traders license while working for Blimling and Associates, a dairy brokerage and research firm.

Prior to join Dean Foods I spent six years with

Foremost Farms USA, Cooperative. While at Foremost I helped to establish a forward contracting program for producers and customers. My responsibilities at Foremost also included federal orders and external milk supply relationships.

In June of 2004, I joined Dean Foods as its Manager of Dairy Risk Management and Commodity Procurement. Since then I've been promoted to my current position.

While at Dean I've been involved in price forecasting, federal orders, state regulations, policy analysis, and other projects. I've testified at five federal order hearings on behalf of Dean Foods. And while I've not testified in a California hearing before, I have attended several California hearings and helped develop Dean's position concerning those hearings.

Dean Foods owns and operates nine plants in California. Four of these are fluid processing plants, which are located in Buena Park, City of Industry, Riverside, and Hayward. Dean also has an ice cream plant in Buena Park, two cultured plants located in Fullerton and Tulare, and two UHT operations located in City of Industry and in Gustine.

My testimony on behalf of Dean Foods is in support of the Dairy Institute of California proposal for modifying the formula to create the Class 1 prices in California to be more reasonably aligned with the surrounding markets. Management of Dean Foods has approved my testimony.

Before continuing in testimony, I wish to thank the Department for including the Dairy Institute's proposal in this hearing. I represented Dean in the discussion with other Dairy Institute members to develop this proposal. Further, I thank you for the opportunity to testify in support of the proposal.

In the interests of time and so as to not insult the Panel's memory and intelligence, I would simply like to remind them of testimony by Ernest Yates on this topic given at the May 3rd, 2005, hearing entered into this record as Exhibit 43. Dean Foods stands behind all the points and arguments that were made in that testimony.

In today's testimony, I hope to build, further clarify, and update that testimony to support and illustrate the points provided by Dairy Institute's testimony so the Secretary can clearly see the California's Class 1 pricing formulas must be changed to become reasonably aligned with contiguous states and to maintain the remaining California Class 1 sales.

Further, I hope to show how the current California pricing regulations have not maintained reasonable alignment. Since California has no ability to control the flow of out-of-state milk, either in raw or packaged form, this misalignment has created opportunity for unregulated milk.

California's current Class 1 differential is too high relative to other similar utilization markets. The growth of California's milk production continues to outpace the demand for Class 1 milk. There are multiple documents provided in CDFA exhibits that clearly illustrate the weakening per capita consumption of milk, flat-at-best Class 1 sales, and growing California milk supply. The record -- excuse me. The result of these conditions alone has diluted the Class 1 utilization. Maintaining this inflationary pricing is costing Class 1 sales, which are likely not recoverable.

Out-of-state milk is continuing to take business away from in-state processors. There are two types of out-of-state milk. Both out-of-state processed milk and out-of-state bulk milk result in deterioration of the California pool value. A large number of industry allies successfully sought national legislation to correct a problem that had allowed out-of-state processors to capture Class 1 sales that historically belonged to California dairymen through packaged milk sales into California.

Both the Alliance and Western United in their petitions acknowledge the passage of S 2120, the Milk Regulatory Equity Act, and its effect of closing a regulatory loophole. We agree that a loophole has been closed. We are appreciative to find California dairy producers and California processors on a more level playing surface. However, I want to caution CDFA and California dairy producers from believing that the doors are closed and locked. There are still opportunities and economic incentive for the existing regulation to be short-circuited, because CDFA can't stop current out-of-state milk entering California nor prevent new out-of-state milk from entering the state.

Thus we advocate for protecting the long-term health of the Class 1 sales that historically belonged to California dairymen by lessening the economic incentive to make long-term investments in process capacity either outside the state for the purpose of capturing California's Class 1 market or inside the state utilizing out-of-state bulk milk.

Our concern is that with the historical price spread between surrounding farm milk prices or, worse yet, the spreads created by the Alliance and Western United's proposals applied historically, would create opportunities to attract out-of-state, unregulated, milk. If people who watch markets for investment opportunities would expect those spreads to remain over time, that would provide an incentive to invest to capture those dollars rather than them staying in the California pricing system.

Out-of-state milk is not disappearing from competing with in-state processors. To connect that caution with the current environment, we are continuing to see aggressive out-of-state competition particularly in the southern marketing area. Dean Foods has lost sales at our Swiss Dairy and Alta Dena operations, as we have testified before. Those lost sales, like all lost sales, are hard to get back. When customers are offered -- excuse me. When customers were offered significant price advantages that we were unable to compete with because of our regulated disadvantage, they switched.

Table 1 shows how much the competitive advantage would have been with today's hauling rates. These rates were much lower in past years, providing the competition an even greater unregulated advantage.

We understand business and competition. We further understand that change is seldom made unless it is justified. Therefore, we have not had an opportunity to pick back any lost business as the new suppliers are doing a good job of serving their customers.

Our concern is that petitioners' changes that are being considered at this hearing could create an opportunity for investment that would lead to another round of erosion in California's packaged milk sales from unregulated milk. This competition is well established in the marketplace and is not going to suddenly pick up and move. The lost sales could return to California processors with California milk, but it will be a very slow process. Thus, we would urge CDFA to recognize that such competitive opportunities still exist and the outcome of this hearing is crucial to provide the proper environment whereby California milk processed by California plants can be competitive.

Out-of-state milk -- bulk milk remains a threat. While the MREA affected certain packaged milk entering California, the risk from out-of-state bulk purchases lingers. From exhibits provided by CDFA, it is clear that such is more than hypothetical. CDFA Exhibit 6c9 shows that in the past five years such imports have averaged nearly 1 billion pounds per year. When one evaluates the economic value of such transactions, it's easy to see why it started and continues.

From Table 2, one can see the price advantage from purchasing milk from Maricopa County and handling it -- excuse me -- hauling it to southern California to be used in Class 1 milk. As is shown in the first column, the advantage is generally decreased over time, especially recently. This decrease is a function of the California Class 1 price being moved by different factors than the federal order prices, the same argument that led to the original petitioner's request for this hearing and the rationale behind Dairy Institute's proposal. The next two columns show what would have been the effect had their proposal been in effect in the same period. When one evaluates these numbers, one can see the cost advantage of out-of-state milk under the Alliance, Western United's, and Dairy Institute's proposal. It is illogical to think that this price advantage could be increased at the rate requested by either the Alliance or Western United and not have the effect of increasing the imports.

The next to the last column shows the effect of the Institute's proposal. While the Institute's proposal does not completely remove the advantage of out-of-state milk, it does lessen the spread and provides for a more consistent spread over time.

I would like to take this moment to make a point about the effect of the institute's proposal that on the surface appears to be self-defeating. If you look at 2006, you will see that the current price advantage is 16 cents, while the Institute's -- under the Institute's proposal it would increase to 22 cents. Dean Foods recognizes that times are difficult for dairy producers, especially in California with the increase in energy and feed costs. Under these conditions it would appear completely self-serving to ask for a sufficient -- for a change sufficient to ensure that California would never be disadvantaged relative to any surrounding market. We think now is not the time to take such an aggressive approach. Instead it is our hope that the Secretary would make a change in the Class 1 price formula that would help it track more consistently in all market conditions than the current formula.

We understand, with that being said, that it means a price increase for our plants under the current market conditions. Admittedly it isn't the level of increase being asked for by the petitioners, but Dean Foods believes that Dairy Institute's proposal will have the effect of lessening economic incentive for unregulated milk in enough market conditions that the short-term increase relative to existing formulas is a reasonable compromise.

California producers are being hurt. As we have testified before and have alluded to in this testimony, this attack from unregulated milk is not limited to producers -- excuse me -- processors alone. Indeed, California dairy producers are also affected. Unregulated milk coming into the state in either packaged or bulk is displacing California Class 1 sales. This unpooled or unregulated milk reduces the value of the state pool and California dairy farmers receive fewer dollars. Over the past five years, every hundredweight of Class 1 milk sales lost by California to out-of-state milk is a loss of $2.82 on average from the pool. When these effects are totaled, they represent a loss of about $148 million from the California milk pool, as illustrated in table 3.

Now, this bitter-sweet action to change the Class 1 formula needs to be taken to help secure the remaining value to stay in the pockets of its logical recipients, the California dairy farmers. As Class 1 dollars exit the state pool, the overbase price is being eroded. Left unchecked, even in the current regulatory environment, overbase prices could decline until they will not sustain the California quota system.

Not just a southern California problem. It's easy to assume that this problem is confined to southern California. Admittedly that is where we have experienced the most aggressive pressure. However, there are several out-of-state alternatives available for northern California processors wishing to avoid paying California's Class 1 price.

In Table 4, I've presented a summary purchasing out-of-state milk into California, comparable to the one provided for southern California in Table 2. When one examines the table, the same conclusions can be drawn. The advantage has generally diminished over time and adopting either the Alliance or Western United's proposal would enlarge the advantage. Like in southern California, the Institute's proposal would increase the advantage over current market conditions, but lessens the advantage over a broader range of market conditions.

To reiterate the point, if we are going to take the most aggressive approach in approaching the Department, we would -- excuse me. To reiterate the point, if we were going to take the most aggressive approach in approaching the Department with this hearing, we would have asked for a decrease in the northern area sufficient to keep northern processors competitive with this threat.

Summary. California has for a long time been an island and its decisions had little effect beyond its borders. Today that isn't the case. The California dairy industry is quite dynamic and has many sophisticated players. These players are all determined to survive. The past provides us proof that competitive factors, i.e., unregulated advantage, will be exploited. Dean Foods urges the Secretary to take action now to prevent further deterioration of market conditions rather than to find itself looking back and crying over spilled milk. We believe the action needed is offered in the Dairy Institute's proposal, which we completely endorse and ask the Secretary to adopt.

Thank you for allowing me to testify and express the views of Dean Foods Company. I would happy to answer any questions. And at this time point we respectfully request the opportunity to submit a post-hearing brief.

HEARING OFFICER AYNES: If there's a post-hearing brief period, you may file a post-hearing brief.

Are there questions from the panel?

DAIRY MARKETING BRANCH CHIEF IKARI: On page 3 where you're testifying about the out-of-state milk, and you've indicated Dean Foods has lost sales, I'm just wondering if the volume has changed from the last testimony that you provided last year, if the volume's about the same or has it changed?

MR. KINSER: As I understand it, it is about the same. It maybe increased a little bit, but it's for all intents and purposes about the same.

DAIRY MARKETING BRANCH CHIEF IKARI: That's all I have.

HEARING OFFICER AYNES: Any further panel questions?

AGRICULTURAL ECONOMIST GOSSARD: On page 4 of your testimony, Table 2, the column on the far right, "Bulk Milk Imports," is this total bulk milk imports to California, bulk milk imports just into southern California, or just bulk milk imports used as Class 1?

MR. KINSER: I need to check, but I believe it's bulk milk imports used as Class 1.

AGRICULTURAL ECONOMIST GOSSARD: Okay.

MR. KINSER: I will confirm that. And if provided the opportunity to file a brief, I would note that.

AGRICULTURAL ECONOMIST GOSSARD: Thank you.

No further questions.

HEARING OFFICER AYNES: Are there any other Panel questions?

Thank you for your testimony.

The next witness will be Sharon Hale.

Would you state your name and spell your last name.

MS. HALE: Sharon Hale H-a-l-e.

(Thereupon Ms. Hale was sworn, by the Hearing Officer, to tell the truth, the whole truth and nothing but the truth.)

MS. HALE: I do.

HEARING OFFICER AYNES: What organization do you represent?

MS. HALE: Crystal Cream and butter Company.

HEARING OFFICER AYNES: And what would be the number of members of that organization?

MS. HALE: We're a proprietary company.

HEARING OFFICER AYNES: And by what process was your testimony finalized?

MS. HALE: The president of the company approved it.

HEARING OFFICER AYNES: Okay. Do you wish to submit this document as an exhibit?

MS. HALE: Yes, I do.

HEARING OFFICER AYNES: Your document is identified as Exhibit No. 53.

(Thereupon the above-referenced document was marked by the Hearing Officer as Exhibit 53.)

HEARING OFFICER AYNES: You may proceed with your testimony.

MS. HALE: Well, that's a good number. That was the year I was born.

(Laughter.)

MS. HALE: Mr. Hearing Officer and members of the Panel. My name is Sharon Hale and I am Vice President, Dairy Policy and Procurement for Crystal Cream and Butter

Company. Our company operates a fluid processing plant in Sacramento and distributes a full line of dairy products to customers throughout northern California.

Crystal is a member of the Dairy Institute of California and participated in the development of the alternative proposal submitted by that organization for today's hearing. The alternative proposal enhances the ability of California's Class 1 price formula to generate prices that more closely track Class 1 prices in surrounding federal orders. We recognize the drift that has occurred because California has not included the impact of dry whey prices in its Class 1 pricing formula and support corrective modification as a result of this hearing.

The Dairy Institute also proposes to realign Class 1 butterfat and solids-not-fat component prices and adjust the overall Class 1 price to a level that is consistent with sound economic principles, the structure of California's market, and current competitive conditions.

Dr. Schiek, the witness for Dairy Institute, provided detailed economic justification for the alternative proposal along with specific points of statutory compliance. Crystal was in full support of his testimony and the position of the Dairy Institute at this hearing.

Crystal has sold dairy products from our Sacramento base for over 100 years. We've grown with the population and expanded to the point of having a presence in most of the counties in northern California, either by direct sale or through a large network of independent distributors. We have a great deal of knowledge about the competitive environment in this market and routinely share this information in our testimony at pricing hearings. Today we plan to provide an update on the situations which are pertinent to the call of the hearing, separating in-state from out-of-state competitors.

Out-of-state competition. It's primarily north of Sacramento where we encounter milk that's been bottled at plants located in surrounding states. The states of Oregon, Washington, and Nevada continue to be the source of packaged milk moving into northern California. This has been the case in the past and remains so today.

The majority of the packaged milk we see is from Darigold, a farmer-owned cooperative with fluid plants in Washington and Oregon. Ray's Food Place Market, a chain of 20 stores spread throughout the northern California counties, buys their private label milk from Darigold. The northernmost locations of WinCo Foods, a large chain of employee-owned box stores, receives both private label and branded milk from Darigold. Cash N Carry Stores, a supply source for many small convenience stores/gas stations, stocks Darigold as well. Pro Pacific, a produce supplier with a distribution center in Redding, is aggressively pursuing restaurant business in northern California and serving Darigold products to the accounts they acquire. Predictably, Darigold continues to be a factor along the border areas of the north state as well.

In the past year we learned Umpqua Dairy, an independent dairy company located in Roseburg, Oregon, was serving Dutch Brothers Coffee, a growing chain of coffee houses with California outlets in Woodland, Chico, Redding, and along the coast. Once limited to Dutch Brothers, it appears Umpqua is making presentations to selective retailers in the region. If one considers the challenges of supplying isolated locations of a chain customer, it makes logical sense to seek "fill-in" business along the delivery route to minimize the overall cost of serving the account. In fact, this exact scenario is one of our greatest concerns when someone new enters the market. We all know the pressure to fill the truck can create some very unstable competitive conditions.

To the east, milk continues to move over the border from Model Dairy in Reno, Nevada. In the South Lake Tahoe area, competitive activity seems to be escalating. However, the overall footprint has not changed much since the May 3rd and 6th, 2005, hearings. With prices in northern Nevada mirroring those in northern California, it is essential all milk sold on this side of the border meet California's minimum component standards for fluid milk and we strongly urge the Department to remain diligent in its enforcement of these standards. Lesser components have the effect of lowering raw product costs and putting California processors at an absolute competitive disadvantage.

Based upon what we've seen, our out-of-state competitive activity in the north is similar to the conditions we reported in our May 3rd, 2005, hearing testimony. If one considers a Class 1 price difference of 60 to 70 cents her hundredweight and the high diesel prices of the past two years, a substantial increase in packaged milk moving into the state would have surprised us. It should be noted, however, that the price difference we cited relates to raw product cost and not to the total cost of producing a gallon of milk. We feel it's very reasonable to assume the cost of operating a plant in Oregon is decidedly less than the cost of doing business in California, thus providing an offset to the announced price differences commonly used to compare California prices to those in surrounding states.

The amount of packaged fluid product being sold in our marketing area indicates the price relationship between California and the states surrounding northern California is not a barrier to entry. We are concerned that by lowering the differential via the petitioner's proposals the competitive position of out-of-state processors will be enhanced, thereby improving their ability to gain the larger share of California's Class 1 market. We believe California's Class 1 usage is low enough and the focus should be on looking at ways to capture sales, not lose them.

In-state competition. Customers routinely shift back and forth between the independent processors in northern California as we compete for business, but growth in the eight valley counties north of Sacramento, which includes Butte, Colusa, Glenn, Shasta, Sutter, Tehama, Yolo and Yuba, is causing the competition to intensify further north than in previous years. According to the Department of Finance, population has increased 11 percent in this area since 2000, 1 percent greater than the growth experienced by the state as a whole. With the growth of chain accounts, be they grocery, box, drug, restaurant, or convenience stores, companies tend to follow their customers into non-historic marketing areas. Consequently, companies are branching out and competition is escalating.

Last year Producers Dairy, a producer-distributor located in Fresno, acquired most of the school business in the Redding area. They now have a depot ten miles south in Anderson; and with the help of four distributors, are aggressively pursuing all types of business in that area.

Foster Farms, another producer-distributor, also serves some accounts in the north end of valley. And we anticipate Berkeley Farms will soon target the same area as they follow their corporate accounts north.

One of Crystal's greatest frustrations through the years has been the benefit accruing to the very limited number of fluid processors in this state who also known dairy farms. Known as the P-D exemption, this benefit has been around since the creation of milk pooling in 1969 and is limited to those who owned dairy farms at that time. It's a closed club whose beneficiaries have shrunk in number to five but whose individual operations have grown tremendously.

Over the past five years, the raw product cost advantage based on announced minimum prices for producer-distributors on their exempt milk has averaged 84.4 cents her hundredweight. That equates to 7 cents per gallon. To put that into perspective, Crystal's pricing lists are generally calculated in mils because business is often lost or gained at the fourth decimal place. Seven cents per gallon represents an enormous disadvantage to those of us who do not receive the P-D benefit yet compete for business with these same companies. Premiums on top of the regulated price only make the situation worse.

The impact of both the Alliance and Western United's proposals, should they be adopted, will be to raise Class 1 prices and subsequently increase the P-D advantage. We do not feel we should be disadvantaged further in the marketplace and oppose modifications in the Class 1 price formula that further enhance the P-D benefit.

Conclusion. On the subject of establishing prices, the Legislature has given the Department significant direction. The challenge arises from the governing statutes not being laid out in priority order, but instead require the Department to consider all pertinent sections in reaching a hearing decision. We believe the alternative proposal from the Dairy Institute is superior in satisfying the criteria set forth in the statutes and should be adopted as a result of this hearing.

Thank you for the opportunity to testify. And that concludes my written testimony.

We do request the opportunity to file a

post-hearing brief.

HEARING OFFICER AYNES: If there is a post-hearing brief period, you may file a post-hearing brief.

MS. HALE: Thank you.

HEARING OFFICER AYNES: Are there questions from the panel?

Hearing none.

Thank you for your testimony.

MS. HALE: Thank you.

HEARING OFFICER AYNES: The next witness will be Jim Gruebele.

Would you state your name and spell your last name.

DR. GRUEBELE: James Gruebele G-r-u-e-b-e-l-e.

(Thereupon Dr. Gruebele was sworn, by the Hearing Officer, to tell the truth, the whole truth and nothing but the truth.)

DR. GRUEBELE: I do.

HEARING OFFICER AYNES: What organization do you represent?

MR. GRUEBELE: Land O' Lakes, Incorporated.

HEARING OFFICER AYNES: And how many members are there of that organization?

DR. GRUEBELE: California there are 275

California members.

HEARING OFFICER AYNES: And by what process did the organization finalize your testimony?

DR. GRUEBELE: The board read the testimony yesterday and approved it.

HEARING OFFICER AYNES: Do you wish to submit this document as an exhibit?

MR. GRUEBELE: Yes, I do.

HEARING OFFICER AYNES: All right. Your document will be identified as Exhibit 54.

(Thereupon the above-referenced document was marked by the Hearing Officer as Exhibit 54.)

DR. GRUEBELE: Okay. That was not the year I was born.

(Laughter.)

HEARING OFFICER AYNES: You may proceed with your testimony.

DR. GRUEBELE: My name is James Gruebele, Dairy Industry Consultant. I'm testifying in behalf of Land O' Lakes, Incorporated.

Land O' Lakes is a dairy cooperative with over 3300 dairy farmer member-owners. The cooperative has a national membership base, whose members are pooled in the California Milk Stabilization and Pooling program and six different federal orders. Land O' Lakes members own and operate several cheese, butter-powder and value-added plants in the upper, midwest, east and California.

Currently, our 275 California member-owners supplies us with over 15 million pounds of milk per day that are processed at our plants in Tulare and Orland.

I'm here to testify in support of the Alliance of Western Milk Producers proposal to increase the California Class 1 price by about 39 cents per hundredweight. The code refers to the fact that the Class 1 price in California needs to be in reasonable relationship with Class 1 prices in contiguous markets. Table 4, revised, of the Summary Analysis of Estimated Impacts shows that the Phoenix Class 1 price was 55 cents per hundredweight higher than the southern California price for the period January 2002 through November 2006. But for the 11 months of 2006 price difference was 96 cents per hundredweight. The reason was the whey factor in federal order formula. The Alliance proposal would reduce the difference in the Class 1 price to 16 cents her hundredweight between Phoenix and the southern California market for the period January 2002 through November 2006 and reduce the difference in Class 1 price to 58 cents per hundredweight for the 11-month period in 2006. When comparing the Class 1 prices in surrounding markets to the weighted average

Class 1 prices for California as shown in Request B, the differences are somewhat larger.

The Alliance proposal also changes the relationship between the California Class 1 fat and Class 1 skim prices. Table 3, revised, of the Summary Analysis of Estimated Impacts shows that the farm cost of whole milk in California for the period January 2002 through November 2006 was 4.6 cents per gallon less than the farm cost of whole milk in Phoenix. But the farm cost of California lowfat milk for the same period was 11.7 cents below the farm cost of Phoenix lowfat milk. With the Alliance proposal, the farm cost of whole milk in California would be 1.2 cents per gallon lower than the farm cost of whole milk in Phoenix. With the Alliance proposal, the farm cost of lowfat milk in California would have been 7 cents per gallon lower than the farm cost of lowfat milk in Phoenix for the same period. The adjustment in the Class 1 fat formula and the alignment in Class 1 skim price as proposed by the Alliance helps to bring the lowfat milk, reduced fat milk, and skim milk more in alignment with Phoenix as well as other contiguous federal order markets.

The Alliance proposal would still leave the California Class 1 prices lower than in the Phoenix market but it would bring the prices into more reasonable relationship not only with the Phoenix market but also with the Cost 1 prices in other contiguous markets.

It is important to note that the code also refers to the reasonableness and economic soundness of market milk prices for all classes in relation to the cost of producing and marketing milk for all purposes; that prices established shall insure an adequate and continuous supply of milk in relationship to the demand for milk for all purposes; and that prices, including the prices of components of milk, bear a reasonable and sound economic relation to each other.

Land O' Lakes is concerned about the importation of milk from surrounding markets. Figure 14 in the Hearing Background Resource shows that about 1.3 to 1.4 million pounds of milk per day were imported from Nevada and Arizona, for each state, in the past 12 months. This is a very significant amount of milk. The bulk milk shipped into the state from neighboring states is not pooled; and because much of the milk is use for Class 1 purposes, the importation of that milk erodes the pool revenue for California producers.

Land O' Lakes urges the state to maintain some caution in raising Class 1 prices in California. According to the document issued at the prehearing workshop on the Summary Analysis of Impacts, Table 4 revised, shows that the current difference between the southern California Class 1 and the Phoenix uniform price averaged a dollar thirty-four per hundredweight for the period January 2002 through November 2006. With the Alliance proposal this difference would increase to a dollar seventy-three cents per hundredweight. Of course, the Yuma Class 1 differential is 25 cents lower than the Phoenix Class 1 differential, and this difference also applies to the uniform price.

This means that the Alliance proposal -- that with the Alliance proposal the difference between the southern California Class 1 price and the uniform price would have been a dollar ninety-eight cents per hundredweight for the period January 2002 through November 2006.

It is important to note that the current difference between the southern California Class 1 price and the Phoenix uniform price for the 11-month period in 2006 was 93 cents per hundredweight. So the difference in these prices were smaller in 2006 than for the period January 2002 through November 2006.

In addition, fuel costs increased the last couple of years. And this would suggest that hauling costs also increased. But an increase in the California Class 1 price could encourage additional milk being imported into

California from surrounding states. And that could mean additional losses of Class 1 revenue for California producers. In spite of this threat, net-net, Land O' Lakes is of the opinion that the overall pool revenue for producers in California would be enhanced with the Alliance proposal.

Western United Dairymen proposal is similar to the Alliance proposal, but it would slightly increase the risk from out-of-state milk. The Dairy Institute proposal had some merit, as it addresses the relationship of Class 1 price changes over time. But their proposal would have reduced the Class 1 prices for the period January 2002 through November 2006. Therefore, LOL urges the Secretary to adopt the Alliance proposal.

Milk prices have been low in California in 2006. The increase in the Class 1 milk prices as proposed by the Alliance would be of welcome assistance to California producers. Not only are producer prices low, but feed costs have increased significantly in recent months. The Alliance Class 1 proposal would help to alleviate some of the current price cost squeeze faced by California producers.

To conclude, LOL recommends the adoption of the Alliance proposal.

This concludes my testimony. I would like the opportunity to file a post-hearing brief.

Thank you.

HEARING OFFICER AYNES: If there is a post-hearing brief period, you may file a post-hearing brief.

Are there questions from the panel?

DAIRY MARKETING BRANCH CHIEF IKARI: I have a question.

Dr. Gruebele, you indicated that -- you indicated that the Dairy Institute's proposal has some merit. If its proposal was revenue neutral, in other words it didn't drop the price level, would you -- would Land O' Lakes' position -- well, what would Land O' Lakes' position be with respect to Dairy Institute's proposal?

DR. GRUEBELE: We would still recommend the Alliance proposal. Unfortunately, we do not address all of the issues with the Alliance proposal. But at this particular point the board is of the opinion that we need a Class 1 price increase.

DAIRY MARKETING BRANCH CHIEF IKARI: And in preparing your testimony, did you perform any analysis on the competitiveness of California products and the competition from bulk or packaged products into California?

DR. GRUEBELE: Well, only to the extent that the

Department provides some data. And that data of course I've referred to in my testimony.

DAIRY MARKETING BRANCH CHIEF IKARI: Thank you.

HEARING OFFICER AYNES: Are there further Panel questions?

Thank you for your testimony, Dr. Gruebele.

Next witness will be Jim Dolan.

Would you state your name and spell your last name.

MR. DOLAN: My name is Jim Dolan D-o-l-a-n.

(Thereupon Mr. Dolan was sworn, by the Hearing Officer, to tell the truth, the whole truth and nothing but the truth.)

MR. DOLAN: Yes, I do.

HEARING OFFICER AYNES: What organization do you represent?

MR. DOLAN: Driftwood Dairy.

HEARING OFFICER AYNES: And how many members are there of that organization?

MR. DOLAN: We're a private entity.

HEARING OFFICER AYNES: And what process was used to finalize your testimony?

MR. DOLAN: Management formulated it.

HEARING OFFICER AYNES: Do you wish to submit this document as an exhibit?

MR. DOLAN: Yes, I do.

HEARING OFFICER AYNES: This will be Exhibit No. 55.

(Thereupon the above-referenced document
was marked by the Hearing Officer as
Exhibit 55.)

HEARING OFFICER AYNES: You may testify.

MR. DOLAN: Mr. Hearing Officer and members of the Hearing Panel. My name is James Dolan and I represent Driftwood Dairy in El Monte, California. My testimony today has been assembled and approved by the management of the company.

We are a privately owned company and operate a fresh milk plant in southern California. We distribute our products throughout the entire Los Angeles and Inland Empire marketing areas.

I thank the Secretary for the opportunity to testify today, as Class 1 pricing is very important to the prosperity of our business. The markets we serve are very cost sensitive and will move from one supplier to another over a very small price difference. It's very important that our Class 1 milk costs be in close alignment with most of our out-of-state competitors.

In a past, when the differential of the price between states has imbalanced, we have had incursions into our market by out-of-state processors.

We support the testimony given by Bill Schiek, as it will stabilize the differential between California and neighboring states Class 1 producer prices. Class 1 is presently less than 15 percent of the total milk market and per capita consumption continues to decline.

The Federal Marketing Service has just announced a public hearing to take evidence on a proposal to amend Class 1 price in adjoining federal orders. Any changes made here also need to be taken into consideration when evaluating the Class 1 pricing.

Violent price swings always cause a disruption to the market. So a formula that produces a fair price without excessive price fluctuation is what we need. I believe that Dr. Schiek's proposal does that.

Thank you for the opportunity to testify today. And I do request the opportunity to file a post-hearing brief.

HEARING OFFICER AYNES: If there is a post-hearing brief period, you may file a post-hearing brief.

Are there any questions from the Panel?

Hearing no questions.

Thank you for your testimony.

Our next witness will be Albert Nunes.

Would you state your name and spell your last name.

MR. NUNES: Albert Nunes N-u-n-e-s.

(Thereupon Mr. Nunes was sworn, by the Hearing Officer, to tell the truth, the whole truth and nothing but the truth.)

MR. NUNES: I do.

HEARING OFFICER AYNES: And what organization are you representing?

MR. NUNES: I'm a partner in the Genske Mulder Company. We're an accounting firm. We do approximately 20 percent of the milk in California, our clients. We also have dairy clients in about 27 other states.

HEARING OFFICER AYNES: Okay. And what process was utilized to finalize your testimony?

MR. NUNES: I used cost studies that our firm prepares to analyze changes over a period of time; and my experience doing my job, along with talking to a couple of my partners to get their opinions.

HEARING OFFICER AYNES: You may proceed with your testimony.

MR. NUNES: My testimony is more towards a change has to happen for dairymen. What's before us right now is Class 1, so I would be in favor of that. My reasons that I'm going to come about are going to be more related to the dairy -- everything's going -- the processor side.

One of the things I hear a couple of times, and we've gone on for a while, is dairymen basically overproduce and they're causing their own problem. There's some truth to that. But there's also a flaw in that analysis. And dairymen cannot control the price it sells its product for. He can't choose to produce a different product or go into a different line that makes money. All they can do is control its costs. Therefore, the only way to control his costs is economy of scale. They get bigger.

As an example, I went back and I looked at our cost studies. And I looked back in the year December of 1990. Cost of production was $11.53. This cost of production did not include living cost or any principal reduction. It was just cost to operate the dairy. The average herd size was 931 cows.

I go ten years later, which is December of 2000. The average cost of production was $11.34. They decreased their costs by 19 cents. But they milked 1,568 more cows. The herd size increased by 68 percent to be able to -- they decrease their costs a little bit by doing it. And I guaranty in that period of time lower cost went up. But the economy of scale helped them make a business decision that they could stay in and operate and be competitive in the state.

They're price takers, you know. The normal -- as I said before, the normal economic model doesn't fit a dairyman. Cows aren't machines. I can't say, "Okay, this is raw milk price here. I'm going to close my plant down and close my cows down until we get through it and open back up." You can't do with the cows. It's a live animal. You've got to keep them going.

When they add more cows, particularly this last year, this year we're going through right now, they're still losing money. It's just at a lower rate. When I hear some of the testimony referring to processors -- and processors need to make money just like everybody else. It's needed to encourage people to stay in the state. But the gist that I'm getting is they're making money, just not as much. Dairymen say they're losing money. And it's not at a small peace.

California right now has a competitive advantage. We have a mature industry. When you go to a town that has a lot of dairies there's four or five supply guys, there's four or five repair guys, there's four or five banks, there's accountants, there's attorneys. There's plenty of work for them to do. And that competition helps keep their prices lower.

When you go to other states -- I'm going to use as an example Kansas. I happened to be visiting it not too long ago. That's an industry that's getting started. But they're a young industry. They don't have enough milk. There's no -- there's no competition amongst supply guys, amongst repair guys, amongst feed guys. They don't have the competitive advantage that we have here to have our costs cheaper. But sooner or later it's going to happen there. And then once they do, they're costs of production are going to be way lower than ours. And at that time you're going to start to see people have a big decision to make: "Do I want to go to another state? Because I can produce a lot cheaper and get a lot higher price than I can here."

California's been known as the most profitable state. For the first time in recent memory the State of Washington is now more profitable than California when we look at the last ten years cumulative. We have other states getting closer and closer.

The limiting factor is that some of these newer states that have newer dairies in them now are just getting started, so they're highly leveraged. They tend to have higher interest costs, higher depreciation costs; they get newer buildings; they're having to buy cattle at current market prices, which are very high, which are affecting their profitability. But as time goes by and they lower their debt, they start to raise their own heifers, they're going to lower their costs.

Another competitive disadvantage California's got is, you know, we have -- our land costs are at least 5,000 bucks an acre more than almost any state that I know that I go to see that's, you know, reasonable. When I turn that to a cost, that's $115 a cow a year, or 55 cents a hundredweight. Now that doesn't affect us right now because right now our industry is what it is. You're not going to expand, nobody's buying new. But sooner or later this land price is going to cause the dairymen to say, "You know what, my place is worth so much darn money, I don't want to sell it. And I can take this profit and leverage it and go to a place and milk two times the amount of cows with the same money I had in California."

There's nobody here going to be able to afford to buy that because with your income -- they try to do that, it doesn't work. I had a young couple in my office just yesterday. They have a thousand cows. They want to buy a dairy. They want to bear dairy milk. It'll milk 1500 cows. They can expand to it. When you run the numbers, to be able to buy that place -- and it's priced cheap in terms of what other dairies are going for -- that person would have their hundred cows paid for -- heifers paid for, 750 paid for. To buy that place they would have to fully leverage their cows. They'd pay up to 62 percent leveraged on the cows and 100 percent financial on the real estate. That means they're fully leveraged to be able to buy a place. And they're going as -- were no debt on their cows. That same dynamic is going to go forward to anybody who wants to buy an existing dairy in this state that wants to come in new. People sell and leave. It's going to be really hard for somebody to come in and buy and stay in this place, and stay and operate in California.

We have -- I have paid attention to what's been going on the last couple of hearings -- and I fully respect your job. You have a hard job. You've got to try to make the state happy, the people happy, businesses happy. And you're never going to win. You're going to lose no matter where you turn. But when I see decisions made, they seem to give a lot of impetus to businesses. Processors seem to get more favorable ear than the dairyman, who's called a producer. I wish you would call dairymen processors, because then the mindset's going to be these are businesses in the state of California who operate decent sized businesses.

We have dairies in places where if it wasn't for the dairy, we would have areas where nobody -- none of the people would live in. As an example, I live in the town of Hilmar. Hilmar is greatly supplied by dairies. There's a lot of dairies out there. When you take a dairy, the average dairy in the state of California is about 900 cows, my understanding. But that's the average. If you take the median -- we still have quite a few small dairies. If you take the small dairies out, I'm going to guess it's closer to 1100 or 1200.

Each dairy is going to have at least 12 employees. When you take that, they also have -- they hire all these services and operate in these small states.

A simpler example of what I'm trying to say. I have a client that's been in Kansas. There's a little town called Bird City. The city has about 5 to 600 people in it. They are ready to close down. There's not enough kids in the school to keep their school days open and all that. Their was two wealthy bankers who left about $12 million to the city. And they said, "You can use this money for one reason, to make sure you help the city."

They've been trying for three or four years to finance something. Nothing seems to work, because everything you do is just -- you know, they'll build a nice community center. Big deal. They still need business.

What they did is they gave a client of mine -- to build an 1800-cow dairy from scratch, buy 1800 cows, and all he had to put down was $200,000. They financed the rest of it. The reason being was that dairy was enough to keep that small town open, reopen the school because there's enough kids from that dairy working to create school days. It was enough to keep a restaurant open. And it was enough to open a local -- supply store. That's one 1800-cow dairy. Bring that and extrapolate that into the cities we have now, our rural areas, that things going on. It's hard to measure and you can put a number to it. But that's there. If we don't do something to at least make our dairymen -- they're losing a lot of money right now. Our cost studies show 88 cents a hundredweight. If I take quota out, it's probably like dollar ten per hundredweight through June. The average dairy in this cost study's about 1900 cows. That means the regular dairy, 4 to 600, is probably losing a buck thirty, a buck forty a hundred, or about 2 to $300 a cow. We're not talking about making money or making more money. They were losing money.

Now, everybody is losing money. It's not just California. I'm not saying that we need some -- California needs some special treatment. But it has to be addressed. If we don't do something, we'll -- you'll see no effect today. But eventually dairies are going to leave the state. Other states are going out of their way to convince dairies to come. They know they have a lot of rural areas that can be propped up and be semi -- a good place to live. People are going to have decent jobs. And they're going do it. They're doing it all the time. I've been seeing it happen for three or four years.

Once people leave this state as -- we're referencing, you know, same thing as a consumer -- you're not going to get them back that easy. They're going to be angry and they're going to want to go.

The last thing I wanted to go over was -- when I look at my numbers, I explained I looked at the year December of 1990, average cost was eleven fifty-three. I looked at the year 2000, the average cost was eleven thirty-four. The increased herd size, 68 percent to do that.

I looked at our cost studies from June of '06. Average cost of production was $13.03. Cow numbers increased from 2000 to 2006, basically a little over five years, 24 percent. That increase wasn't done. And my guess the cost of production it's going to be probably 13.20, 13.30. That cost -- everybody's talking about feed costs. That is a real cost. Feed cost right now, with this corn price going nuts because of ethanol, who knows where it's all going to end up. A lot of feeds are based off of a -- a lot of prices are based off the corn market.

My estimate is feed costs will increase 50 to 80 cents a hundred in '07 when the new contracts are put out and people have to buy their product -- their feeds for next year.

Hay is also going up, basically because it's silage. Basically every feed goes up when corn goes up. Everybody tries to get on the bandwagon. That's just how it seems to be.

That's the extent of what I have to say.

HEARING OFFICER AYNES: Are there any questions from the Panel?

Hearing no questions.

Thank you for your testimony.

MR. NUNES: I respectfully request a post-hearing brief also.

HEARING OFFICER AYNES: If there is a post-hearing brief period, you may file a post-hearing brief.

MR. NUNES: Thank you.

HEARING OFFICER AYNES: Thank you.

Next witness will be William Van Dam.

Please state your name and spell your last name.

MR. VAN DAM: My name is William C. Van Dam. Last name is spelled V-a-n D-a-m.

(Thereupon Mr. Van Dam was sworn, by the

Hearing Officer, to tell the truth, the
whole truth and nothing but the truth.)

MR. VAN DAM: Yes, I do.

HEARING OFFICER AYNES: What organization do you represent?

HEARING OFFICER AYNES: I represent Milk Producers Council.

HEARING OFFICER AYNES: How many members are there in that organization?

MR. VAN DAM: We represent 100 dairies located in southern California.

HEARING OFFICER AYNES: And what was the process finalizing your testimony?

MR. VAN DAM: Process of finalizing my testimony was to combine the action taken at my board meeting on November 14th with the conference call we had on November 30th which established the criteria for the testimony.

HEARING OFFICER AYNES: Okay. Do you wish to submit this document as an exhibit?

MR. VAN DAM: Yes, I do.

HEARING OFFICER AYNES: This will be Exhibit 56.

(Thereupon the above-referenced document
was marked by the Hearing Officer as
Exhibit 56.)

HEARING OFFICER AYNES: You may testify.

MR. VAN DAM: Mr. Hearing Officer and members of the Panel. My name is William C. Van Dam. I am the Executive Director of Milk Producers Council, which is located at 5370 Schaefer Avenue in Chino, California.

MPC represents approximately 100 member dairies located primarily in the Chino Basin and in Kern and Tulare Counties.

The position outlined in our testimony was prepared to be consistent with the positions taken by the MPC Board of Directors at their regular monthly meeting held on November 4th, 2006, and in accordance -- that's the 14th, sorry -- and in accordance with additional review and action taken on November 30th in a conference call.

MPC has been in existence for over 50 years and has always represented the interests of the southern California milk producer. We have a long historical interest in the southern California Class 1 market. Nearly all of our members are located in areas that are close enough to the Los Angeles milk bottling plants to participate in serving those plants.

Our best estimates show that currently 25 percent of the fluid milk sold in southern California comes from out-of-state milk or California-produced milk that spends some of its time out of state and comes back looking like out-of-state milk. This is a significant loss of income to the California pool. All of the milk moving into southern California from out of state does so because of the regulatory system that creates incentives to move milk. There is more than enough milk produced in California that is much closer to bottling plants than the milk being delivered from Arizona and Nevada.

Reasons to support a class 1 price increase. There is reason to believe that the Class 1 price in southern California could be modestly increased now without creating meaningful additional incentives to import more milk. The primary factor is that the federal order Class 1 price includes a value for whey that has pushed its price higher by 50 to 75 cents per hundredweight compared to California Class 1 price which does not include a whey factor.

In 2002, not included in the table above, a full year average California Class 1 price was virtually the same as the Arizona Class 1 price. In 2003, Arizona prices averaged 28 cents higher. After that there were significant increases in the value of whey and the Arizona Class 1 price jumped to 90 cents higher than the Class 1 price. In 2005, the Arizona price was 74 cents higher. And so far in 2006 it is 93 cents over.

The result of the higher Class 1 prices in

Arizona has been to reduce the net incentive to move milk into California. Based on market activity and comments by those who know far more about -- more than I do about world protein markets, it appears that the high whey prices will continue for some time. But at some point these prices will decrease. And when they do come down, the incentives to move milk will again increase.

A second factor, which is just a recent occurrence, is that the Arizona blend price has dramatically increased since the addition of first Sara Farms, a former producer-handler which became pooled in April, and then G & H Dairy, a formally unregulated handler became pooled in May. Comparing the pounds of Class 1 sales reported to the Arizona pool in the first six months after the addition of this volume to the same six months of the year before shows that there has been an increase of 40 percent in the volume of Class 1 milk pooled (see Exhibit 1). The difference between the Arizona blend price and the California Class 1 price was reduced by an average of 58 cents her hundredweight. This too improved the situation with regard to the incentives.

Response the Western United and Alliance of Western Milk Producers proposals. Our members, like all other producers in California, are facing huge increases in their cost and desperately need some price relief. Yet they worry that a Class 1 price increase that is implemented as proposed would just add a permanent increase to the difference in price between areas which would be there no matter what the market conditions. The import of milk is bad enough as it stands, and they do not want to see any added incentive put into the system.

With the above in mind, MPC is in support of the increase in the Class 1 price in the range suggested by Western United and the Alliance of Western Milk Producers. They cannot, however, support the method of increase they propose. A fixed price increase as they propose can only be fixed at a hearing called to reduce a Class 1 price.

Response to Dairy Institute alternative proposal. On the other hand, MPC is very supportive of the idea of adding a whey factor to the Commodity Reference Price. We like the method, but here we cannot support the price level that they propose.

The value of whey has become a significant factor in the valuation of milk and properly takes its place along with butter and nonfat dry milk and cheese as products whose value is used to determine prices paid to dairy producers.

Additionally, whether we like it or not, we must be concerned about the relationship between the prices in adjacent federal orders and the California prices.

Therefore, it makes sense to have our formula move with the same factors as those in the federal order. The addition of a whey factor will result in better tracking. By adding a whey value factor as proposed by the Dairy Institute, we can stabilize the incentives that exist between markets and pass the whey-driven price increases to producers. In it's present format California producers are missing out on real milk values that should be available.

We support the addition of the whey formula as proposed by Dairy Institute. We recognize that adding whey to the CRP will add a lot of value to the cheese part of the CRP and that if left in the formula unadjusted, there would be a very large increase in the Class 1 price of over $2 at today's whey prices.

A second reason to adjust the cheese CRP formula is that without adjustment the "higher of" would always, or certainly nearly always, choose the cheese as the "higher of." To the extent possible, we would want the California Class 1 price to be established using the same products as are being chosen in the federal order.

In the federal order formulas the choice was made based on the Class 3 or Class 4 milk prices. Thus they are using a price that is adjusted for make allowance. To mimic that result without wholesale adjustments to the

California system, we suggest that an adjuster be applied to reduce the value of the cheese CRP formula which with make it comparable to the values of butter and nonfat dry milk formulas. Dairy Institute has proposed 85 cents as the proper adjuster. And we can accept that number. We submit, however, that a more logical choice would be 98 cents, which is the difference in the federal order formulas between the total make allowance per hundredweight applied to Class 3 and Class 4 milk.

But here is where we depart from the Dairy Institute's proposal. There is no reason to reduce the "plus" differential used in establishing the Class 1 price in Article III(A)(2) and (3). Dairy Institute's proposal provides a gain to producers only in conditions of near record levels of whey prices, as we have now. In all other conditions it would be a net reduction of the Class 1 price. This is not acceptable, and MPC does not support the addition of a whey value to the CRP if the current 64.4 cent plus differential is reduced, let alone reduced to a negative number.

When whey value was added to the CRP and the 85 cent adjuster suggested by Dairy Institute is applied and there is no adjustment to the differential, the Class 1 price increase in October would have been 74 cents. If the 98 cent adjuster were used, the Class 1 increase would be 61 cents. We recognize that when dry whey prices drop below 17 cents per pound, that the California Class 1 price would be lower than it is under the current formula. This is an acceptable result to us, however, because producers will get to participate in the higher whey-driven prices when available and the new alignment will keep incentives to move milk into southern California at a stable level.

The use of the larger cheese CRP adjuster of 98 cents yields a price increase closer to that proposed by Western United and Alliance of Western Milk Producers. Plus it has the advantage of being a logical choice because it represents a relevant factor in the choice of the "higher of" base price. For these reasons we prefer the 98 cent adjuster.

The issues that make it so difficult to establish a Class 1 price in California are in the history of milk regulation not unique to California. The very core of the issue is the inability of one regulating body, the State of California, to regulate milk from other states. Federal orders were established over half a century ago to deal with precisely these same issues. The interstate commerce clause of the United States Constitution is a powerful clause and it cannot be easily circumvented. The solution then was the federal order system which still operates reasonable well. This state in order to get the advantages it sees in self-regulations pays a price in terms of milk imports that drain the pool of value that we are powerless -- we are largely powerless to stop.

What we can control is the level of incentives, and these must be watched closely or the volumes of out-of-state milk will grow.

This concludes my prepared testimony.

HEARING OFFICER AYNES: Are there questions from the panel?

AGRICULTURAL ECONOMIST GOSSARD: Mr. Van Dam, first a simple question, on the first page of your testimony.

Was that board meeting the 14th or the 4th of November?

MR. VAN DAM: 14th.

AGRICULTURAL ECONOMIST GOSSARD: Okay. Third paragraph of that page: "Our best estimates show that currently 25 percent of the fluid milk sold in California comes from out of state."

Do you mean that -- does that 25 percent include both packaged or just 25 percent of bulk milk products sold in California plants is out of state?

MR. VAN DAM: That's a good question. What we did was we started with everything we knew about bulk milk and where it came from. And to that we added our best estimate of what is being imported in packaged form from Arizona. And the two together generate the 25 percent number.

AGRICULTURAL ECONOMIST GOSSARD: Thank you.

No further questions.

ASSOCIATE AGRICULTURAL ECONOMIST BORISS: I just have one.

The 98 cents, is that with new ruling from USDA or --

MR. VAN DAM: Yes, that is. That's the new prices.

ASSOCIATE AGRICULTURAL ECONOMIST BORISS: Okay. That's all.

HEARING OFFICER AYNES: Are there any other panel questions?

DAIRY MARKETING BRANCH CHIEF IKARI: I just have a question.

It looks like it's on.

On page -- I guess it's your second full page of testimony where you talk about you cannot support the method of increase they propose -- the fixed price increase as they propose can only be fixed at a hearing.

Can I interpret that -- or maybe you can clarify that. Would an MPC support a temporary increase in the

Class 1 price?

MR. VAN DAM: Well, that is basically what we're proposing by using the whey factor in it because it would go up and down according to the value presented to the formula by whey.

Don't know what you would mean by a temporary increase. If you'd say for six months or so, I suppose we would. I'd prefer a system that moves and floats with things and generates the result.

But producers -- other witnesses representing producers have made it clear that producers are really desperate for some additional income. And that would be acceptable, as long as it's not just one month.

DAIRY MARKETING BRANCH CHIEF IKARI: Did MPC consider any of the consequences of raising the price and adding incentive to chronic production increases?

MR. VAN DAM: That is the primary concern expressed by our organization. And this is an attempt to roughly replicate conditions that existed back in 2002-2003, feeling that that incentive -- if we could devise a system that would maintain that kind of incentive and not get bigger than that, that we would have a satisfactory result. So they're very concerned about the incentives. And I was instructed to make sure we present testimony that does not in the long run create added incentives. Obviously increasing the price now, no matter how you do it, adds to the incentives that exist right now. The point of our testimony is that those have narrowed substantially and we believe that we could stand to adjust upward without causing any additional movement of milk into state.

DAIRY MARKETING BRANCH CHIEF IKARI: And that's with the understanding that over the last 20 years, California's averaged 4 percent increase in production per year.

MR. VAN DAM: I'm only talking about a Class 1 and what's happening with the milk coming into southern California. That is the issue before this hearing. Those increases have occurred. They haven't incurred in southern California.

DAIRY MARKETING BRANCH CHIEF IKARI: Okay. Thank you.

HEARING OFFICER AYNES: Are there any further panel questions?

Thank you for your testimony.

MR. VAN DAM: You're welcome.

I would like to have the honor of submitting a post-hearing brief.

HEARING OFFICER AYNES: If a post-hearing brief period is granted, you may file a post-hearing brief.

MR. VAN DAM: Thank you.

HEARING OFFICER AYNES: Next witness would be Kevin Abernathy.

Please state your name and spell your last name.

MR. ABERNATHY: Kevin Abernathy A-b-e-r-n-a-t-h-y.

(Thereupon Mr. Abernathy was sworn, by the Hearing Officer, to tell the truth, the whole truth and nothing but the truth.)

MR. ABERNATHY: Yes, I do.

HEARING OFFICER AYNES: What organization do you represent?

MR. ABERNATHY: The California Dairy Campaign.

HEARING OFFICER AYNES: And how many members are there in your organization?

MR. ABERNATHY: I believe based on the last tabulations from one of my colleagues, that would be about 196.

HEARING OFFICER AYNES: And what process was used to finalize your testimony?

MR. ABERNATHY: It was originally discussed at the November board meeting and then it was finalized with my CDFA Petitions Committee the day before yesterday.

HEARING OFFICER AYNES: And do you wish to submit this document as an exhibit?

MR. ABERNATHY: Yes, please.

HEARING OFFICER AYNES: Your document is identified as Exhibit No. 57.

(Thereupon the above-referenced document was marked by the Hearing Officer as Exhibit 57.)

MR. ABERNATHY: Thank you.

HEARING OFFICER AYNES: You may proceed with your testimony.

MR. ABERNATHY: Mr. Hearing Officer and members of the Panel. Again, my name is Kevin Abernathy. I currently serve as the Executive Director of the California Dairy Campaign. I'm testifying today on behalf of the dairy producer members who we represent throughout the state. The testimony I will present today is based on positions that were adopted by CDC's Board of Directors.

We testify today in support of the position put forward by Milk Producers Council calling for an addition of the dry whey factor to the Commodity Reference Price, including the whey factor -- or the whey value in the CRP would limit the fluctuation between California Class 1 prices and the federal order price received in surrounding states.

The federal milk marketing order formulas include a dry whey factor, and California's pricing formulas should do the same in order to bring the prices into a closer relationship with federal order prices.

We strongly oppose the portion of the petition put forth by Dairy Institute calling for price adjustments that would substantially reduce the California Class 1 price. Adding a dry whey factor to the CRP would bring California Class 1 prices in a more reasonable relationship with those received in surrounding states. Decreasing the Class 1 price, as called for by the Dairy Institute, would widen the gap between federal order and California prices.

We also applaud and support the efforts of the Alliance and Western United to increase Class 1 prices. But we consider it important as well to eliminate the variation between federal and state prices. The adoption, in our opinion, of the Milk Producers Council's position would accomplish both objectives.

The California Dairy Campaign would like to thank the Department for the opportunity to testify today.

And if a post-hearing brief is granted, we would respectfully like to submit one.

HEARING OFFICER AYNES: If there is a post-hearing brief period, you may file a post-hearing brief.

Any questions from the panel?

DAIRY MARKETING BRANCH CHIEF IKARI: Just a point of clarification. And perhaps I should have asked Bill Van Dam this question. But he -- perhaps he could address it in his post-hearing brief.

The position that you've taken, does that -- what does that mean in terms of your position with respect to the Alliance and Western United's proposal? Are you neutral or do you oppose their proposals?

MR. ABERNATHY: We support an increase in producer prices, Mr. Ikari.

DAIRY MARKETING BRANCH CHIEF IKARI: But if you support their proposals for increasing the price?

MR. ABERNATHY: Yes, if it will have an overall impact in increasing producers' prices at the current levels, that would be correct.

But I think it goes back to when we first testified, I believe it was last year, on bringing it into a more reasonable proximity between federal order and California prices according to -- I can't remember the number off the top of my head -- that this also plays partly into that equation.

So we felt that based on the testimony that Bill provided for Milk Producers Council, that was fairly close to what we originally had proposed to the Department over a year ago.

DAIRY MARKETING BRANCH CHIEF IKARI: No further questions.

HEARING OFFICER AYNES: Are there any further panel questions?

Thank you for your testimony.

Is there anyone else who wishes to testify?

Having received no additional requests to give testimony, this hearing is closed with the exception of those witnesses who have requested the opportunity to file post-hearing briefs.

The request for a post-hearing brief period by the witnesses is granted. The witnesses shall be provided the opportunity to submit a brief amplifying, explaining or withdrawing their testimony. In order for the brief to be considered, the Department must receive the brief by 4 p.m., December 11th, 2006. The brief may be sent or delivered to the Department's Dairy Marketing Branch located at 560 J Street, Suite 150, Sacramento, California 95814. The brief may also be faxed to the Dairy Marketing Branch at area code 916-341-6697 or sent by e-mail to dairy at CDFA dot CA dot GOV.

This hearing is closed.

(Thereupon the Department of Food and Agriculture Market Milk Hearing adjourned at 12:55 p.m.)

CERTIFICATE OF REPORTER

I, JAMES F. PETERS, a Certified Shorthand Reporter of the State of California, and Registered Professional Reporter, do hereby certify:

That I am a disinterested person herein; that the foregoing Department of Food and Agriculture, Dairy Marketing Branch hearing was reported in shorthand by me, James F. Peters, a Certified Shorthand Reporter of the State of California, and thereafter transcribed into typewriting.

I further certify that I am not of counsel or attorney for any of the parties to said hearing nor in any way interested in the outcome of said hearing.

IN WITNESS WHEREOF, I have hereunto set my hand this 11th day of December, 2006.

JAMES F. PETERS, CSR, RPR
Certified Shorthand Reporter
License No. 10063