Hearing Panel Report

Based on a Public Hearing Held On An Emergency Basis
November 9, 2009

Addressing the Class 1, 2, 3, 4a, and 4b Pricing Formulas
Contained in the
Stabilization and Marketing Plans
for Market Milk for the
Northern and Southern California Marketing Areas

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Based Upon a Public Hearing Held on November 9, 2009

This Report of the Hearing Panel regarding proposed amendments to the Stabilization and Marketing Plans for Market Milk for Northern California and Southern California (Plans) is based on evidence received and entered into the Department of Food and Agriculture's hearing record. The evidence includes the Departmental exhibits, written statements and comments received from interested parties, written and oral testimony received at a public hearing held on an emergency basis November 9, 2009, and written post-hearing briefs.

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INTRODUCTION/WITNESSES

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

Two petitions were submitted by:
1. Alliance of Western Milk Producers (AWMP)
2. Western United Dairymen (WUD)

Five alternative proposals were submitted by:
1. Milk Producers Council (MPC)
2. Dairy Institute of California (DI)
3. California Dairy Campaign (CDC)
4. California Dairy Women Association (CDWA)
5. California Dairies, Inc. (CDI)

A total of 21 witnesses testified including the Department's witness:

*Mike Francesconi, Department
*AWMP, William Van Dam
*WUD, Michael Marsh, Tiffany LaMendola
*MPC, Geoffrey VandenHeuvel, John Kaczor
*DI, William Schiek
*CDC, Lynne McBride, Scott Magneson, Joaquin Contente
*CDWA, Linda Lopes
*CDI, Eric Erba
Hilmar Cheese Company (Hilmar), John Jeter
The Kroger Company (Kroger), John Hitchell
Genske, Mulder & Company, Pete Hoekstra
*Land O'Lakes, Inc. (LOL), Tom Wegner
Super Store Industries (SSI), Dennis Brimhall
Saputo Cheese USA Inc. (Saputo), Greg Dryer
Unified Grocers, John Bedrosian
Farmdale Creamery (Farmdale), Scott Hofferber
Kraft Foods (Kraft), Mike McCully
Nestlé USA (Nestlé), Patricia Stroup
John Rossi Hay Company, John Rossi
A.L. Gilbert Company, David Gilbert
Leprino Foods Company (Leprino), Sue Taylor

Also entered into the hearing record were additional written comments submitted by:
Lactalis American Group Inc.
Western Milling Quality Feeds
Security Milk Producers Association
Cathleen Galgiani, California Assemblymember

* Indicates submission of a Post Hearing Brief

Background: California's Dairy Landscape

The following economic data and statistics reflect the California dairy situation at the time of the hearing and were considered when examining and evaluating the proposals and testimony submitted at the hearing.

Cost of Producing Milk

- For 2008, the cost of producing milk increased in all four areas of the state when compared to the same period for the previous year, with statewide average costs at $16.48 per hundredweight (cwt.) (up $2.52/cwt. from 2007). When including return on investment and management, the cost of producing milk in 2008 was $18.48/cwt. (up $2.71/cwt. from 2007).
- For the first quarter of 2009, the statewide average cost of producing milk was $16.67/cwt., while the second quarter of 2009 average cost of producing milk was $15.37/cwt.
- For the first six months of 2009, compared to the first six months of 2008, the statewide average cost of producing milk was $16.02/cwt. (up $0.28/cwt. from 2008). When including return on investment and management, the average cost of producing milk for the six-month period January-June 2009 averaged $17.82/cwt. (up $0.14/cwt. from the same period in 2008).
- Looking at the last five years, comparing the second quarter of 2009 to the second quarter of 2004:
  - total feed costs in 2009 account for 59.0 percent of the total cost of production, compared to 54.5 percent in 2004;
  - California "milk cow" hay costs averaged $203/ton in 2009, compared to $142/ton in 2004.

Mailbox Milk Prices

- California: mailbox milk prices for the 12-month period July 2008 through June 2009 averaged $12.70/cwt., $5.76/cwt. lower than the average for the same time period ending in June 2008.
- For the six-month period January-June 2009, the mailbox milk prices averaged $9.92/cwt., a considerable decrease compared to the average mailbox milk price for the same time period in 2008 of $16.85/cwt.
- Federal Orders: mailbox milk prices for the twelve months ending June 2009, averaged $13.47/cwt.

California Milk Production

- Annual milk production has *increased* at an average rate of 4.1 percent over the last 10 years.
- For January-September 2009, milk production has shown a -3.8 percent decrease compared to the same time period in 2008.

Milk Cows

- Most recent cow number reports indicate that for September 2009 compared to September 2008, California reported a decrease in the number of dairy cows by 73,000 head.
- Annual California cow numbers have increased at an average rate of 2.8 percent over the last 10 years – while U.S. cow numbers have increased 0.2 percent over the last 10 years.

- For 2008, California had more dairy cows and produced more milk than any other state, yet ranked 5th in milk production per cow, and 8th in total number of licensed dairies.

Class 1 Usage

- For 2008, 14.3 percent of California's total pooled milk production was used to produce packaged fluid milk.
- For January-September 2009, Class 1 sales showed no change in total production when compared to the same time period in 2008.

Cheese Production (Class 4b)

- In 2008, 43.2 percent of California's total milk production was used to produce Class 4b products.
- For January-September 2009, Class 4b product production was down -2.9 percent when compared to the same time period in 2008.
- For 2008, California cheese production decreased to 2.11 billion pounds, a level not seen since 2005.
- For 2008, the California and other western states share of total U.S. cheese production decreased to 42.4 percent, compared to 2007. For California production alone, the U.S. market share was 21.3 percent for 2008.

Butter and Nonfat Dry Milk (NFDM) Production (Class 4a)

- In 2008, 34.3 percent of California's total milk production was used to produce butter and NFDM.
- For January-September 2009 (when compared to the same time period in 2008), total butter production was down -7.0 percent and total nonfat dry milk production was up 9.3 .
- California is ranked first in the U.S. for butter and NFDM production, and when combined with the other western states, the U.S. market shares are 50 percent and 72 percent, respectively. For California production alone, the U.S. market share is 34 percent and 54 percent respectively.
- California butter production has shown a 43 percent growth in production over the last 5 years to 555.5 million pounds in 2008.

Cottage Cheese, Yogurt, Ice Cream, as well as other soft and frozen dairy products (Class 2 and 3)

- For 2008, 8.2 percent of California's total milk production was used to produce Class 2 and 3 products.
- Frozen dairy product growth since 2003 has been relatively flat, however 2009 has shown a steady increase in production over the previous year.
- In 2008, total cottage cheese production was relatively flat compared to 2004 and 2009 has continued to show this trend.
- Yogurt production has increased 28 percent since 2004 and 2009 continues to show a similar growth trend.

SUMMARY OF THE PROPOSALS

Alliance of Western Milk Producers

Proposed the following permanent changes to the pricing formulas:

- Increase Class 1 price by $0.50/cwt.
- Increase Class 2 and 3 prices by $0.26/cwt.

Western United Dairymen

For the temporary time period January 1, 2010 – June 30, 2010:

- Increase Class 1, 2, 3, 4a and 4b pricing formulas by $0.50/cwt.

Milk Producers Council

Proposed the following permanent changes to the formulas:

- Changes to the Class 1 and 4a pricing formulas:
  - Replace the California Weighted Average Price (CWAP) for nonfat dry milk (NFDM) used in the Class 1 and 4a formulas with the published National Agricultural Statistics Survey (NASS) price for NFDM.
- Changes to the 4b pricing formula:
  - Modify the 4b formula so that when the NASS dry whey price exceeds $0.35/lb. the additional value (apart from the $0.25/lb. fixed whey factor) would be split 50/50 between producers and processors.
- Changes only to the Class 1 pricing formula:
  - Replace the average Dry Whey West price published in the Dairy Market News used in the Class 1 formulas with the weighted average dry whey price reported by NASS.

Dairy Institute

For the temporary time period January 1, 2010 – March 31, 2010:

- Increase all classes of milk $0.20/cwt. – only to be implemented if both the announced Class 4a and Class 4b milk prices in the second prior month do not exceed $13.00/cwt.

California Dairy Campaign

- Incorporate the CDFA announced Cost of Production in the Class 1 price formula by using the “higher of” the Commodity Reference Price (CRP) or the most current Cost of Production value in the calculation of the Class 1 price.
- Incorporate the Commodity Credit Corporation (CCC) Dairy Support Program purchase price for butter in the Class 4a and 4b formula by using the “higher of” the average CME price or the CCC price for butter when calculating the price.
- Incorporate the Commodity Credit Corporation (CCC) Dairy Support Program purchase price for NFDM in the Class 4a formula by using the “higher of” the CWAP price or the CCC price for NFDM when calculating the price.
- Incorporate the Commodity Credit Corporation (CCC) Dairy Support Program purchase price for cheese in the Class 4b formula by using the “higher of” the average CME price or the CCC price for cheese when calculating the price.
- Establishes a variable manufacturing cost allowance for the Class 4a and 4b pricing formulas by taking the value of the current fixed manufacturing cost allowance multiplied by the ratio of the Commodity Reference Price value divided by the announced Cost of Production value.

California Dairy Women Association

For the temporary time period January 1, 2010 – December 31, 2010:

- Calculate the Class 1, 2, 3, 4a, and 4b prices by using the latest California Cost of Production value multiplied by the following values to obtain component prices by class:
  Class 1: Class 1 fat 30%; SNF 53%; fluid carrier 17%
  Class 2: Class 2 fat 35%; SNF 65%
  Class 3: Class 3 fat 35%; SNF 65%
  Class 4a: Class 4a fat 35%; SNF 65%
  Class 4b: Class 4b fat 35%; SNF 65%

California Dairies Inc.

- Increase the f.o.b. California price adjuster for butter from $0.0309 to $0.0475 per pound of fat.
- Increase the manufacturing cost allowance for butter from $0.1560 to $0.1740 per pound of fat.
- Increase the manufacturing cost allowance for NFDM from $0.1698 to $0.1965 per pound of SNF.

Table 1: Estimated Impacts of Hearing Proposals on California Class 1, 2, 3, 4a, 4b, and Pool Prices

- The table below shows the impacts of the petition and alternative proposals on class and pool prices relative to current prices from October 2004 through September 2009.
- The analysis assumes that the petition, alternative proposals and current formulas were in effect throughout the entire period.
- When a change is a "plus", the proposal would have increased the price.
- When a change is a "minus", the proposal would have decreased the price.

Table 1 - **Estimated Impacts[1] on Class 1, 2, 3, 4a, 4b, and Pool Prices if the hearing proposals had been in effect for the 5-year period: October 2004 to September 2009**
Annual and Five-Year Averages

	Class 1 Northern ($/cwt.)	Class 1 Southern ($/cwt.)	Class 2 Northern ($/cwt.)	Class 2 Southern ($/cwt.)	Class 3 Statewide ($/cwt.)	Class 4a ($/cwt.)	Class 4b ($/cwt.)	Pool[2] ($/cwt.)
Alliance Proposal								
2004-2005	+$0.50	+$0.50	+$0.26	+$0.26	+$0.26			+$0.10
2005-2006	+$0.50	+$0.50	+$0.26	+$0.26	+$0.26			+$0.10
2006-2007	+$0.50	+$0.50	+$0.26	+$0.26	+$0.26			+$0.10
2007-2008	+$0.50	+$0.50	+$0.26	+$0.26	+$0.26			+$0.10
2008-2009	+$0.50	+$0.50	+$0.26	+$0.26	+$0.26			+$0.11
5-year average	+$0.50	+$0.50	+$0.26	+$0.26	+$0.26			+$0.10
Western United Dairymen Proposal *(TEMPORARY)*								
2004-2005	+$0.50	+$0.50	+$0.50	+$0.50	+$0.50	+$0.50	+$0.50	+$0.51
2005-2006	+$0.50	+$0.50	+$0.50	+$0.50	+$0.50	+$0.50	+$0.50	+$0.51
2006-2007	+$0.50	+$0.50	+$0.50	+$0.50	+$0.50	+$0.50	+$0.50	+$0.51
2007-2008	+$0.50	+$0.50	+$0.50	+$0.50	+$0.50	+$0.50	+$0.50	+$0.51
2008-2009	+$0.50	+$0.50	+$0.50	+$0.50	+$0.50	+$0.50	+$0.50	+$0.51
5-year average	+$0.50	+$0.50	+$0.50	+$0.50	+$0.50	+$0.50	+$0.50	+$0.51
Milk Producers Council Proposal[3]								
2004-2005	-$0.06	-$0.06	+$0.12	+$0.12	+$0.12	+$0.13	$0.00	+$0.03
2005-2006	-$0.06	-$0.06	+$0.14	+$0.14	+$0.14	+$0.13	$0.00	+$0.03
2006-2007	+$0.11	+$0.11	+$1.02	+$1.02	+$1.02	+$1.06	+$0.68	+$0.71
2007-2008	-$0.11	-$0.11	+$0.05	+$0.05	+$0.05	+$0.01	+$0.07	+$0.02
2008-2009	+$0.02	+$0.02	+$0.12	+$0.12	+$0.12	+$0.14	$0.00	+$0.06
5-year average	-$0.02	-$0.02	+$0.29	+$0.29	+$0.29	+$0.29	+$0.15	+$0.17
Dairy Institute Proposal *(TEMPORARY)*								
2004-2005	+$0.20	+$0.20	+$0.20	+$0.20	+$0.20	+$0.20	+$0.20	+$0.20
2005-2006	+$0.20	+$0.20	+$0.20	+$0.20	+$0.20	+$0.20	+$0.20	+$0.20
2006-2007	+$0.20	+$0.20	+$0.20	+$0.20	+$0.20	+$0.20	+$0.20	+$0.20
2007-2008	+$0.20	+$0.20	+$0.20	+$0.20	+$0.20	+$0.20	+$0.20	+$0.20
2008-2009	+$0.20	+$0.20	+$0.20	+$0.20	+$0.20	+$0.20	+$0.20	+$0.20
5-year average	+$0.20	+$0.20	+$0.20	+$0.20	+$0.20	+$0.20	+$0.20	+$0.20
California Dairy Campaign Proposal[4]								
2004-2005	$0.00	$0.00	-$0.17	-$0.17	-$0.17	-$0.19	-$0.44	-$0.28
2005-2006	+$0.61	+$0.61	+$0.03	+$0.03	+$0.03	+$0.11	-$0.01	+$0.12
2006-2007	+$0.03	+$0.03	-$0.08	-$0.08	-$0.08	-$0.30	-$0.49	-$0.33
2007-2008	$0.00	$0.00	-$0.51	-$0.51	-$0.51	-$0.32	-$0.47	-$0.35
2008-2009	+$4.66	+$4.66	+$0.55	+$0.55	+$0.55	+$0.73	+$0.54	+$1.32
5-year average	+$1.06	+$1.06	-$0.04	-$0.04	-$0.04	$0.0	-$0.17	+$0.10
California Dairy Women Association Proposal[4] *(TEMPORARY)*								
2004-2005	-$2.51	-$2.78	-$0.94	-$1.17	-$0.89	-$2.88	-$3.91	-$3.20
2005-2006	+$0.20	-$0.08	+$0.46	+$0.23	+$0.51	-$0.85	-$0.73	-$0.55
2006-2007	-$2.85	-$3.12	-$0.68	-$0.91	-$0.63	-$4.18	-$2.93	-$3.09
2007-2008	-$4.61	-$4.88	-$3.50	-$3.73	-$3.45	-$4.11	-$4.92	-$4.48
2008-2009	+$4.98	+$4.71	+$5.02	+$4.79	+$5.07	+$4.06	+$3.32	+$3.96
5-year average	-$0.96	-$1.23	+$0.07	-$0.16	+$0.12	-$1.59	-$1.83	-$1.47
California Dairies, Inc. Proposal								
2004-2005			-$0.38	-$0.38	-$0.38	-$0.38	+$0.01	-$0.13
2005-2006			-$0.38	-$0.38	-$0.38	-$0.38	+$0.01	-$0.13
2006-2007			-$0.38	-$0.38	-$0.38	-$0.38	+$0.01	-$0.13
2007-2008			-$0.38	-$0.38	-$0.38	-$0.38	+$0.01	-$0.15
2008-2009			-$0.38	-$0.38	-$0.38	-$0.38	+$0.01	-$0.16
5-year average			-$0.38	-$0.38	-$0.38	-$0.38	+$0.01	-$0.14

[1] Compares proposed alternative formulas with current California formulas

[2] Quota and overbase price

[3] The historic NASS dry whey and non-fat dry milk commodity averages used in Federal Order pricing were utilized to estimate the impact of this proposal.

[4] The impact analysis for these proposals assumes the Department's Quarterly Cost of Production Summary is released 3 months following the end of the quarter in question.

A HISTORICAL REVIEW:
PREVIOUS DEPARTMENT HEARINGS CALLED ON AN EMERGENCY BASIS

It has been 11 years since the Department called a hearing on an emergency basis to consider adjustments in the pricing formulas. Over the last 21 years the Department called the following five hearings on an emergency basis (beginning with the oldest first):

<u>1988</u>
In 1988, a national drought had caused feed costs to increase significantly and California weather conditions reduced milk production. The Department held an emergency hearing on December 8, 1988, to consider a proposal to increase the Class 1 prices for six months and floor the Class 4a and 4b prices at a higher level for six months. The Department implemented a temporary floor on the Class 1, 4a, and 4b prices for six months (Classes 2 and 3 had indirect floors through the establishment of floors on Class 4a). These temporary adjustments resulted in an average monthly increase in the blended (Pool) revenues of $0.17/cwt. for the six months.

<u>Fall of 1990</u>
During the fall of 1990, milk prices plummeted, placing California dairy farmers in a cost-price squeeze. California was also entering its fifth year of drought conditions. Increasing financial stress caused by the low milk prices coupled with increasing hay and feed prices caused the California legislature to enact urgency legislation which became effective August 1991. Prior to the legislation, the Department had the authority to increase the Class 1, 2, 3 prices, but the revenues generated by the increases would not be distributed among all producers. Legislation (AB 1232) was enacted on an emergency basis that defined “emergency” as meaning “the existence of a critical condition, as determined by the Secretary, that arises suddenly and unexpectedly, such as, but not limited to, a prolonged dry period drought, or freeze that causes severe economic distress to a significant portion of the milk producers for an extended period of time as a result of rapid increases in operating costs.” The legislation limited any temporary price relief administered by the Department to a maximum limit of 12 months and provided that any temporary increase could be distributed to all milk producers. The Department amended the Pool Plan to accommodate the legislative changes, and implemented a temporary price increase of $0.70/cwt. on Class 1, 2, and 3 for the six-month period ending September 1992. Legislation a few years later was enacted that amended Pooling statutes and was made effective in the Pool Plan by a vote of producers. This new authority implemented the fixed $1.70 differential between the quota price and the overbase price. This fixed differential insured that any increase in the higher valued milk prices would be shared by all producers, thus eliminating the statutory provisions for temporary price and the definition of “emergency” in the Code. These temporary adjustments resulted in an average monthly increase in the blended (Pool) revenues of $0.29/cwt. for the six months.

<u>February and April 1995</u>
On February 17, 1995, the Department held a hearing on an emergency basis to consider a proposal by the AWMP to increase the Class 1 price in order to offset losses experienced by the January heavy rainstorms. No pricing changes were implemented as a result of this hearing. However, on April 21, 1995, after subsequent heavier rainstorms in early March, the Department held another emergency hearing to consider the impact of the flooding caused by these winter storms. This hearing was called on the Department’s own motion, without a petition from dairy stakeholders. The call of the hearing was to consider temporary uniform price increases on all classes of milk, based on the determination that should price relief be

granted, all classes of dairy products should share the responsibility of financing the relief. Following the hearing, the Department implemented a temporary uniform increase on all classes of $0.13/cwt. for eight months.

May 1998

In May 1998, the Department called a hearing on an emergency basis in anticipation of possible Federal Order pricing formula revisions, namely the establishment of a price floor. This hearing resulted in no changes to the California pricing formulas as the Federal Orders did not make any substantive changes to their pricing formulas in response to the USDA public hearing.

In reviewing these prior "emergency" hearings the historical perspective becomes clear. All the actions taken were of a temporary nature. The Panel members are not aware and could not document any evidence to the contrary that any "emergency" hearing in the last 25 years has ever resulted in a permanent increase in the minimum Class price formulas to address emergency conditions.

Prior to the implementation of the fixed $1.70 differential between the quota and overbase Pool price, the Department had to implement temporary changes to all milk classes in order for all producers to share in the added revenues. In accordance with the existing Pool Plan at the time, any increase in the Class 1 price would have only benefited those producers who owned quota. Once the fixed $1.70 differential in the quota price was made effective, it lessened the importance of increasing all the minimum prices to ensure that all dairy farmers would receive a benefit. Nevertheless the four prior "emergency" hearings demonstrate that the policy of spreading the added revenues among all dairy products continued after the implementation of the fixed $1.70 differential.

ECONOMIC CONDITIONS FACING CALIFORNIA DAIRY PRODUCERS PROMPTING THE CALL OF THE HEARING

Compared to farm costs, farm milk prices in California and the U.S. rose to very profitable levels in the latter part of 2007 as the growing world demand for milk and dairy products coupled with production declines by the major suppliers to the world market (Australia and New Zealand) and production limits in Europe impacted the market. California dairy farms were receiving average monthly blend prices above $20/cwt. for the last six months of 2007. These farm milk prices declined by $2-$3/cwt. over the first six months of 2008, but they remained at profitable levels for many farmers, resulting in a growing milk supply.

Even as California's statewide average milk production costs increased to $16-$17/cwt., many producers were still operating profitably. As a result, California dairy farmers, like farmers throughout the world, increased the number of milk cows, which expanded total milk production. When the global economy fell into a recession, the world demand for milk and dairy products collapsed. Suddenly, the global milk supplies were surplus to the amount end users were willing to buy. Farm milk prices across the world plummeted sharply to levels well below milk production costs.

In the latter part of 2008, a number of California cooperatives and proprietary processing plants instituted production limits on the amount of milk they would be willing to receive or purchase from their members or via their supply contracts. Several processors terminated supply contracts with producers. Much of the milk production that was in excess of the quantity demanded by California processors was shipped out of state at much lower prices in order to find a market for the milk. Producers who continued to exceed the production limits incurred the penalties and added expenses associated with successfully marketing the surplus production. These penalties and marketing/hauling fees were sufficient to discourage surplus production.

In California the average blend prices that dairy farmers received fell by over half from the peak of $21.17/cwt. (November 2007) to $10.12/cwt. (July 2009), with $6.00 of the decrease occurring within the four months from November 2008 to February 2009. At the same time, increasing feed grain costs forced production costs higher. The cost of dairy feed doubled from a relatively stable average of about $4.00/cwt. from early 1998 to summer 2006, to over $8.00/cwt. by Spring of 2008. By the end of the first quarter of 2009, the California statewide average milk production cost (excluding return on investment and management) was at $16.67/cwt. of milk production. Many California dairy farms were losing from $5-$7/cwt. on milk produced during the first half of 2009. Based on the Department's production cost survey data, it appears that 94 percent of California dairy farms operated unprofitably during that period. The few California dairies that avoided economic losses were those not dependent upon receiving the state's minimum milk prices, such as organic dairies and dairies that took advantage of forward contracting.

While milk prices have begun to slowly increase in recent months, the prices remained below the cost of production for most dairy farmers. The financial losses, due to the inadequacy of the milk revenues to profitably cover production costs, have moderated over the second half of 2009 –ranging from negative $3-$5/cwt. for most California dairy producers. However the accumulated financial debt and lost equity by the state's dairy farmers has reached major proportions. Information supplied via testimony and the current cost of production trends indicate that the inversion between the milk production cost and milk revenues cost the California dairy industry an estimated $1.4 billion dollars for the time period January-September 2009.

Additionally, based on August 2008-August 2009 Department data and USDA reports, the estimated asset value of dairy cows has dropped by almost $700 per cow (40 percent), which is equivalent to about $1.28 billion dollars for the whole California dairy industry. Unfortunately, real estate values have also declined, which adds to the financial strain the state's dairy producers are facing. Department records reflect that the state lost about 100 dairy farms in 2008. Another 51 California dairies were removed by the voluntary industry whole herd buyout program implemented by the Cooperatives Working Together Program (CWT) in 2009. Based on a recent Departmental survey of producer organizations another 71 dairy farms have also exited the industry in 2009. More California dairy farms are expected to close within the next few months, while most continue to struggle financially.

Consequently for the first time in over forty years, when the state had been averaging an annual increase in total production of 4 percent each year, California's total annual milk production for 2009 is running almost 4 percent below 2008. With modest processing plant expansion this year, California already finds itself short of the necessary milk supply to satisfy the demands of the state's processors.

National dairy industry leaders recognized the severity of the present financial crisis and took action to implement a number of herd retirement programs. In the last 12 months, CWT implemented four herd retirement programs that removed about 250,000 cows in the U.S., which is equivalent to approximately 5 billion pounds of milk production. The last retirement program will be completed at the end of December 2009.

In addition the Secretary of the United States Department of Agriculture took action to: implement a 3-month increase in the purchase price of nonfat dry milk of $0.08/lb. and the purchase price of block Cheddar cheese by $0.18/lb.; order the direct payment of over $700 million to dairy producers in FY 2009 under the Milk Income Loss Contract Program; and change the Federal Dairy Export Incentive Program to enhance dairy exports on the world market. Additionally, Congress enacted and the President signed federal legislation that allocated $350 million to USDA to help alleviate the current dairy crisis.

Meanwhile the global demand for milk and dairy products began to stabilize and the total world milk production declined. When those factors were combined with the impact of the four U.S. herd retirement programs and USDA's intervention in the market, U.S. dairy prices began to increase. If these favorable economic conditions persist, then U.S. farm milk prices should continue to strengthen.

Even though California's milk production declined every month in 2009 compared to the same month in the prior year, the nation's total milk supply did not similarly respond. U.S. total production continued to increase for the first half of 2009. It wasn't until the nation's total milk supply began to reflect monthly reductions in August over the same month the prior year that the milk prices in the U.S. began to slowly increase. Total U.S. milk production was estimated to be -0.1 percent lower in August 2009 and -0.5 percent lower in September 2009. California's reduction in cow numbers and total milk production helped reduce the nation's total milk production.

California milk prices have started a slow recovery. From $9.39/cwt. in July 2009, the Class 4b price improved to $12.69/cwt. in October 2009. Based on the current dairy commodity prices, California Class 4a and 4b prices can reasonably expect to be in the $13-$14/cwt. range before the end of the year. At the time of the hearing, the December Class 1 price is estimated to be over $16/cwt. based on the available commodity prices, up from $11.88/cwt. in July 2009. The same trend can be observed with the overbase price: from $9.60/cwt. in July 2009, it increased to $11.04/cwt. in September and at the time of the hearing could expect to be close to $12/cwt. for October. Even though prices are increasing, USDA's October 2009 Livestock, Dairy & Poultry Outlook and other dairy experts are forecasting only modest strengthening of milk prices through 2010. USDA's forecast suggests that the annual all milk price will be $14.70/cwt. for 2010.

Meanwhile, California's statewide milk production costs, without allowances for return on investment and return on management, have moderated, falling to $15.37/cwt. at the end of the second quarter. Should production costs continue to moderate it would enable the milk revenues to profitably cover the costs for most California producers. The nation's harvest of feed crops is still not complete and it remains uncertain where the overall feed cost situation will be this winter. The cost of hay and other forage may become the key to lower feed costs.

If the nation's total milk supply does not increase and continues to decline then milk prices are likely to keep strengthening. There are so many variables that can impact this situation, there is no certainty whether milk prices will continue to strengthen, and if so by how much and how long? It is also unknown whether or not the minimum price increases will reach levels needed to sustain the necessary production levels that California plants will require.

As the year 2009 comes to a close and 2010 approaches, there are a number of uncertainties in the global, national, California, and dairy economies that can materially impact future California farm milk prices. These uncertainties include but are in no way limited to:

- Whether or not the global, national, or state economies sufficiently recover from the severe economic downturn;
- Whether or not the modest demand for milk and dairy products will continue to increase;
- Whether or not total national milk production continues to decrease;
- Whether or not the nation's total milk supply will be in better balance with the nation's commercial demand;
- Whether or not the supplies of feed grains and hay are ample and the resulting feed costs moderate;
- Whether or not dairy operations outside California emerge from the current financial crisis with a comparative advantage to compete in the dairy market.

Nevertheless, given all the facts and data that was a part of the hearing record, the Hearing Panel has concluded that the California dairy economy will finish 2009 with steady increases in farm milk prices. While the outlook for 2010 must be tempered by uncertainty, based on all the evidence available, it appears that farm prices will increase to more profitable levels and production costs will moderate. The Panel recognizes that these projections are quite fragile.

Against that background, the November 2009 hearing was held and interested parties presented comments on the two petitions and five alternative proposals that had been submitted to the Department. Even though opinions diverged, some consensus can be observed. The proposals suggesting permanent structural changes to the formulas drew the most opposition. A. L. Gilbert Feed Company and CDC supported any price increase for producers while Nestlé, Farmdale, Saputo, and Hilmar opposed any changes to the pricing formula at this time.

No producer organization opposed the price increase proposed by the first petitioner, the AWMP. It was opposed by the DI, Kroger, SSI, Kraft and Leprino. The second petitioner, WUD, modified its position at the hearing and no longer supported its own petition. Some parties still testified to it and support was mentioned by MPC but it was opposed by the AWMP, the DI, Kroger, Kraft and Leprino.

The changes proposed in the alternative proposals also received many comments. The alternative proposals submitted by producer organizations did not receive any support from other producer organizations, while the DI received support from five processors. More specifically, the MPC proposal was opposed by the AWMP, the DI, CDI, Unified Grocers and Leprino. The CDC and CDWA proposals were opposed by the AWMP, the DI, CDI, Kroger, LOL, SSI, Unified Grocers, Kraft and Leprino. The CDI proposal was opposed by the DI, CDWA, CDC and Leprino. The DI proposal was opposed by the AWMP and CDI.

PROPOSED CHANGES TO THE PRICING FORMULAS

The various proposals presented at the hearing included a broad spectrum of concepts. While they differed greatly in impacts, they can be classified into two main categories. The first one includes the concepts that would require structural or fundamental changes to the pricing formulas. The other category consists of the proposed changes that would not be fundamental or alter significantly the mathematical construct of the pricing formulas. The first is comprised of the proposals from MPC, CDWA, CDC and CDI, while the latter includes the proposals from WUD, the AWMP and the DI. These two categories will be discussed in the following sections.

Proposed Structural Changes to the Pricing Formulas

Four proposals requested fundamental price formula changes: MPC, CDWA, CDC and CDI. With the exception of CDWA, these proposals were on a permanent basis. MPC requested the use of the NASS NFDM price in the Class 1 and 4a price formulas. They also proposed modifying the whey portion of the Class 4b formula to add 50 percent of the NASS dry whey value exceeding $0.35/lb. to the current $0.25/lb. fixed whey value. CDWA proposed using the cost of production as a basis for each of the class prices. CDC proposed including a cost of production floor in the Class 1 formula, establishing a variable manufacturing cost allowance for Class 4a and 4b and including the federal support price in the pricing formulas. CDI proposed an increase to the manufacturing cost allowance and f.o.b. adjusters of the Class 4a formula. A discussion of each of these issues follows.

Calculating the Pricing Formulas Based On the California Cost of Production

For producers to be able to recoup their input costs in periods of higher costs of production, CDC proposed to permanently include a cost of production factor in the Class 1 pricing formula. More specifically, the Class 1 formula would include the higher of the Commodity Reference Price or the cost of production including allowances (based on the California cost of production data that the Department publishes quarterly).

CDWA proposed to revise the current Class 1, 2, 3, 4a, and 4b pricing formulas for a temporary 12-month period by setting aside the current pricing factors used to establish the monthly prices and basing the minimum prices directly on the California cost of production data that the Department publishes quarterly. CDWA testified that the proposal was designed to resolve the inadequacy of the past minimum prices in covering the production costs over the recent past and that the other proposals would not provide a sufficient price increase to cover the cost of milk production.

While these proposals appear to resolve the financial issues facing dairy producers, they really do not. These proposals do not resolve the fundamental problems that create the low prices and they create unintended consequences that are often far worse than the problem they were designed to resolve.

One of the key principles in establishing statewide minimum prices is that they must be set at a level that will enable the state's production to be successfully marketed. If the minimum price is established at a level to cover the average production cost, there is no downside risk to produce milk. The only market signal that such minimum prices send to dairy farmers is the positive incentive to produce. Theoretically, the more milk a farmer can produce, the more revenues and potential profits rise. Total milk production for all producers would conceivably increase beyond the levels demanded by the commercial market.

It is important to recognize that there is no legal authority that regulates the amount of milk that processors must purchase. If the minimum prices are set at a level that provides no operating margins for processors (the cost of raw milk exceeds the price that a processor can obtain from selling the finished product), then processors have the discretion not to purchase or reduce the amount of milk they purchase from California dairy farmers. Processors also have the choice to purchase milk supplies from out-of-state sources at less than the State's minimum prices, which then displaces milk supplies from California dairy farmers. Such out-of-state milk sources could afford to pay for the transportation cost to ship the milk supply into California and still obtain a better price than they could obtain by marketing their milk in their home region.

Milk supplies that are purchased at prices below the state's established minimum prices by California processors will provide a competitive advantage over processors purchasing milk at state minimum prices. The competitive advantage can become so significant that the processors who are paying the lawful minimum price for their milk supplies will ultimately not be in a position to be competitive. This creates an environment that destroys the minimum price provisions. While the Department can try to do everything in its power to enforce the minimum prices, if the purchases below minimum prices become widespread, California dairy farmers will ultimately suffer the consequences.

If California producers are unable to sell their milk production to California processors, at least in the short run, some of this production could be dumped or offered to out-of-state processors at dramatically lower prices. Most farm milk sales to out-of-state buyers are not subject to minimum pricing regulations and such sales are largely at the discretion of the out-of-state buyers. This situation occurred in 2008 when California producers had to incur substantial hauling expenses for hauling the milk from California to the out-of-state buyers. These producers received significant reductions in the prices they received by out-of-state processors. California producers that receive substantially lower prices and higher costs for hauling the milk to out-of-state processors would at some point realize that they are better off if they offer their milk to a California processor even if they receive less than the established minimum price (in violation of statutes). The magnitude of this problem would determine whether or not the minimum pricing program would be effective.

Incorporating, even for a twelve-month period, the concept of establishing minimum prices primarily based on the cost of milk production increases the possibility that these negative consequences would occur. For this concept to be remotely viable, it would be more logical to implement it on a nationwide basis along with the nationwide requirement that total milk production would be controlled. This is essentially what the Canadian dairy system does, which has been criticized for failing to position the Canadian dairy industry for long term competitiveness. Production control is not expressly authorized in either the California or federal legislation.

If California's average prices that dairy farmers received were established near or equal to the statewide average cost of production level for the first quarter of 2009, then California milk prices would have been near the $18.51/cwt. level (including allowances for return on investment and return on management), when the mailbox prices in most federal orders for the first quarter of 2009 averaged $12.33/cwt. More importantly, the prices dairy farmers received in other nearby western states were lower yet and much more equivalent to California's existing mailbox values of $9.00-$10.00/cwt. Based on the large differences in milk prices that would have existed under this scenario, it is not hard to envision the problems of out-of-state milk supplies entering California in search of higher prices and California processors purchasing out-of-state milk at prices lower than the established minimum price. In essence, the marketing conditions under such a large milk price difference between California and neighboring states would have become untenable.

Whenever there is a deficit in the global or national milk supplies relative to the commercial demand, farm milk prices will be at fairly high levels, often well above the cost of production. Prior to May 1993, California relied on three factors in establishing the Class 1 price, with cost of production representing roughly 40 percent of the input into the pricing formula. When the market was strong and national milk prices were high, California found itself with minimum class prices well below those in other dairy regions in the U.S. At that time California's Class 1 price, which is typically the highest farm price, was below the lowest minimum price of the federal order class prices. This was the fundamental basis for abandoning the cost of production in California's pricing formulas and is sufficient basis for not returning to a system that could lead to that same problem.

This situation is clearly demonstrated over the five-year period October 2004 through September 2009 by the Department's impact analysis of the CDWA and CDC proposals. Over the five-year period, the CDWA proposal would have resulted in dairy producers receiving, on average, a Pool price $1.47/cwt. less than the current pricing formula. While the CDC proposal would have resulted in dairy producers receiving, on average, a Pool price $0.10/cwt. more than the current pricing formula over the entire five-year period, this proposal would have also resulted in a lower Pool price in three out of the five years.

It is clear that basing the pricing formulas on the average cost of production would put the producers in a position to be negatively affected whenever the market price goes above the production cost level. The recent increase in dairy commodity prices provides the strong probability that this would occur again in 2010 if the cost of production was made a significant factor for determining California minimum prices.

The CDC proposal avoids the problem of obtaining lower minimum prices when the market prices are strong by incorporating the requirement that the minimum price will be based on the higher of the market price or the cost of production factor. Clearly, this would lessen the risk of producing milk even further and would add more incentive to create the types of negative consequences which were just discussed.

Panel Recommendation
The Panel recommends not including the Cost of Production in the Class 1, 2, 3, 4a, and 4b pricing formulas.

Manufacturing Cost Allowance and f.o.b. Adjusters

Typically, the manufacturing cost allowances and California f.o.b. price adjusters contained in the Class 4a and 4b pricing formulas are updated during hearings that are focused solely on these two classes of milk. These hearings are preceded by the release of the Department's manufacturing cost studies and California butter/cheese sales data. Industry stakeholders examine and analyze the information released by the Department in order to formulate proposed changes to the formulas. The Department has a long standing history of relying on the audited processing cost study data combined with the relevant economic supply/demand factors to establish the manufacturing cost allowances for butter, nonfat dry milk, and Cheddar cheese and f.o.b. price adjusters. The manufacturing cost allowances and f.o.b. adjusters remain in the pricing formulas until they are amended via a public hearing, where interested parties are provided an opportunity to offer testimony and evidence regarding the audited manufacturing cost data and any relevant economic factors that should be considered in evaluating the appropriate level of the manufacturing cost allowances. In general, there is more time allotted prior to a Class 4a and 4b hearing so that industry stakeholders are able to not only formulate proposals but also analyze alternative proposals made by other organizations. Because of the expedited time frame of this hearing, the California butter/cheese sales data were not even released until after alternative proposals were due.

CDI proposed to change the Class 4a manufacturing cost allowance and f.o.b. adjuster, but supported it only in the event that the Department implemented a change to the Class 4a pricing formula that would increase the Class 4a price. CDI testified that their first inclination was to wait for a Class 4a and 4b hearing to make these proposed changes.

CDC proposed to establish a “variable” manufacturing cost allowance in the Class 4a and 4b pricing formulas that would equal the current manufacturing cost allowance times the Commodity Reference Price divided by the latest California Cost of Production. By using this variable manufacturing cost allowance in the milk price formulas, when the market signals oversupply through low prices, the manufacturing cost allowance would decrease. This would in turn cause manufacturing to slow down. CDC maintains that this would bring the supply and demand in balance, but the Panel is concerned this could also deter plants from purchasing milk when prices are low and milk is plentiful, possibly leaving some producers without a home for their milk. The Panel is cognizant that the California price must be set at a level that will help ensure that California’s production will clear the market. If milk production cannot find a home within California, this can create economic pressure that could undermine the state’s established minimum prices.

While all interested parties were provided an opportunity to testify on the proposed changes to the manufacturing cost allowances and f.o.b. adjusters, no testimony supported these changes. One of the main reasons cited by both processor and producer organizations was that due to the lack of time for this hearing, the complexity of the variable manufacturing cost allowance could not receive the proper amount of time it deserved to be fully analyzed and understood and such changes would be better suited for a hearing called specifically for this purpose. Changes in the manufacturing cost allowances and f.o.b. adjusters tend to be controversial in nature and have significant policy implications for industry stakeholders. The Department considers such changes after careful examination and analysis of Department data and stakeholder testimony.

Table 4 of the Departmental hearing exhibit demonstrates that the approximate percent of the state’s total volume of butter, nonfat dry milk and Cheddar cheese covered by the existing manufacturing cost allowances in the Class 4a and 4b pricing formulas, is 54 percent, 56 percent and 5 percent respectively. The hearing proposals designed to increase producer revenues would lower the percent volumes covered by the existing manufacturing cost allowance to 0 percent for butter, between 0-21 percent for nonfat dry milk and 0 percent for Cheddar. While CDI was clear that the proposals increasing the prices of manufacturing classes of milk, especially Class 4a, would be damaging in both the short and long term to the producers owning processing facilities, there was little testimony regarding how those proposals would specifically affect the volume covered of butter, nonfat dry milk and Cheddar cheese. The Panel believes that there was not sufficient input given by industry stakeholders in the hearing record to enact permanent changes at this time to the manufacturing cost allowances and the f.o.b. adjusters.

Panel Recommendation
The Panel recommends no changes to the Class 4a and 4b manufacturing cost allowances and f.o.b. adjusters.

Whey Value

The value of the protein contained in the whey stream following the cheese making process has been a controversial and complex issue debated greatly by industry stakeholders over a period of many years. A whey factor, consisting of the price of a commodity less a manufacturing cost allowance all multiplied by a yield factor, was introduced into the Class 4b formula in 2003. The whey factor remained in the formula until a contentious hearing held in October 2007 when it was replaced by a fixed factor of $0.25/cwt. The Panel report from the October 2007 hearing highlighted many issues surrounding the valuation of the whey stream and difficulty of including such value in the Class 4b formula.

Following the October 2007 hearing, a Whey Review Committee was formed by the Department to further address how the Class 4b formula should value whey. The Committee consisted of representatives of dairy producers, producer cooperatives, processors, and dairy producer and processor trade organizations. After thoroughly reviewing and analyzing the issue, the Committee recommended continuing with the $0.25/cwt. fixed whey factor.

At the November 2009 hearing in question, a proposal was introduced that would modify the current fixed whey factor of $0.25/cwt. by including a variable factor that would provide additional whey value whenever the price of the NASS dry whey commodity series rises above $0.35/lb. All testimony in the hearing record, other than the organization proposing the change, either opposed making a change or was silent on the issue. Most testimony in the hearing record opposed changes to the whey value in the Class 4b formula because of the considerable attention already given to the topic during past hearings and the Whey Review Committee or because such a change is better suited to be revisited during a more focused hearing on the subject. Some testimony also opposed the proposal because of the lack of time available to examine the concept.

It is important to recognize that there was widespread disagreement among producer and processor interests over the whey factor at the October 2007 hearing. A number of small cheese processors strongly opposed the inclusion of the whey factor, because they could not afford to invest in whey operations and were precluded from obtaining any of the added whey value that the pricing formula had imputed into the price. Small cheese processors in particular testified that whenever the commercial price for dry whey was above the manufacturing cost allowance for dry whey, this added value to the farm price that they could not recover and if the factor was not amended it would require them to terminate their operations. The $0.25/lb. fixed whey factor that the Department implemented at the conclusion of the October 2007 hearing was a delicate compromise of the competing interests. Adding additional value to the Class 4b price whenever the whey price rises above $0.35/lb. would tip that delicate balance in favor of producer interests and could again create long term financial issues for small cheese processors.

The Panel believes the complex and contentious valuation of whey was thoroughly reviewed during the October 2007 hearing and subsequent Whey Review Committee. In light of the lack of support from industry stakeholders for this proposal, the Panel recommends making no changes to the valuation of whey in the Class 4b formula.

Panel Recommendation
The Panel recommends no changes to the whey factor in the Class 4b formula.

Replace the California Weighted Average Price (CWAP) for Nonfat Dry Milk with the National Agricultural Statistics Service (NASS) Survey Price

MPC proposed to permanently replace the CWAP price for nonfat dry milk in the Class 1 and 4a pricing formulas with the NASS published price. Numerous testimonies reiterated the fact that this issue was considered at the August 2007 hearing that included a major focus on the best pricing series to be used for nonfat dry milk in the pricing formulas. Testimony also stressed that in addition to the fact that this issue was discussed and analyzed at the 2007 hearing, a permanent change to the pricing series used in the pricing formulas warrants considerable industry attention and discussion and the expedited timeline of this hearing did not allow for that.

The Department has a long standing policy of pricing milk produced and processed in California on the economic factors that are specific to California. Considering market conditions that affect the State of California requires economic data and factors specific to California, such as the actual values for NFDM received by California plants. By using verified, audited California NFDM price data, supply and demand decisions can be achieved utilizing the correct pricing signals affecting the California market. The Panel feels that a permanent change to the pricing formulas of this nature requires extensive industry discussion, debate, and consensus.

Panel Recommendation
The Panel recommends no change to the NFDM pricing series used in the Class 1 and Class 4a pricing formulas.

Price Floor

To provide a safety net against the record low prices dairy producers have been facing since the end of 2008, CDC proposed to establish a price floor on the Class 4a and 4b price at the federal support purchase prices. More specifically, the commodity prices used in the Class 4a and 4b formulas would be the higher of the CME Cheddar cheese price, the CME butter price, the CWAP, or the federal support purchase prices for cheese, butter and nonfat dry milk.

Currently the federal support purchase price is an indirect safety net for milk prices. The federal government, through the Commodity Credit Corporation, is currently committed to purchase Cheddar cheese, butter and nonfat dry milk at designated target prices. Those established prices are not incorporated in the milk pricing formulas anywhere in the U.S. Therefore, the federal support purchase price creates a soft price floor, and prices can fall below the established prices. The support purchase prices are currently $1.05, $1.13 and $0.80 per pound of Grade AA butter, Cheddar cheese and nonfat dry milk, respectively.

In the 1990s, as the national dairy markets became more market oriented, and as federal dairy policy review more seriously considered the elimination of federal dairy price supports, dairy processors became more focused in obtaining and keeping their commercial customers. Eventually, federal support price programs were eliminated from most other agricultural commodities and it became clearer to large scale operations that it was essential to maintain their commercial customer buyers. Increasingly, manufacturing processors would continue to supply their commercial buyers with product when market prices fell below the support price levels. The federal government's failure to adjust the fees in the support price calculations and the lack of available federal dairy inspectors also added to the disincentive to switch away from commercial customers towards the commodity credit corporation sales. These changes served as the fundamental reasons for discontinuing the flooring of class prices at the federal support price level.

Modifying the pricing formula to ensure a price floor at the federal support purchase price would put California processors at a disadvantage with the rest of the nation as they would have to guarantee a value for Cheddar cheese, nonfat dry milk and butter that is currently not guaranteed under the federal milk marketing orders. The incorporation of the federal support price in California's pricing formulas would especially place California processors at a greater disadvantage during times of depressed commodity markets when competing for sales with unregulated processors on a national basis.

Additionally, no testimony supported this change at the hearing. The major reason cited by both processor and producer organizations was that due to the lack of time for this hearing, the complexity and impact of this proposal could not receive the proper amount of time it deserved to be fully analyzed and understood. The support purchase price was included in the pricing formula for two years but was deemed inappropriate at a later hearing and removed in 2005.

The producers' need for a fair and equitable milk pricing system must be balanced against the need for California dairy products to be competitive within national and international commodity markets. At this time, the Panel feels that the current formulas, without the federal support purchase price floor, achieve that.

Panel Recommendation
The Panel recommends not establishing a price floor on the Class 4a and 4b pricing formulas.

Proposed Non-Structural Changes to the Pricing Formulas

The hearing record includes three proposals that provide relief to dairy producers by increasing class prices without making significant changes to the mathematical construct of the formulas. The AWMP proposed permanently increasing the Class 1, 2, and 3 prices by simply changing the adjusters and differentials that are currently incorporated in the formulas. WUD proposed temporarily increasing all class prices by a uniform amount for a six month period through differentials added to component prices after all mathematical calculations are performed. The DI proposed temporary increases on all class prices by a uniform amount for the period of three months through differentials added to component prices, similar in concept to the WUD proposal. However, the DI proposal also included a trigger mechanism that only allows the temporary price increase to be implemented when both the Class 4a and 4b prices remain below $13.00/cwt.

Even though these proposals all seek to increase class prices in order to provide needed relief to dairy producers, the proposals differ. The proposals differ with respect to whether these changes should be permanent or temporary, whether a select number of class prices or the prices of all classes should be increased, the magnitude of the class price change, and whether a trigger mechanism should be incorporated in the change. A discussion of each of these issues follows.

Permanent vs. Temporary Price Changes

All proposed changes at the hearing were price increases designed to address the financial difficulties facing dairy producers. The general argument given for temporary price increases was that they would provide relief until the prices increase to a sufficient level to become profitable in covering production costs. There were two main arguments in favor of a permanent price change. First, the price alignment of California Class 1 prices compared to Federal Order Class I prices in surrounding states was such that it warranted a permanent price increase. Second, the California Class 2 and 3 prices warranted a permanent price increase because the decrease of these class prices following the October 2008 hearing did not spark the level of increased Pool usage one may expect. A discussion of permanent price changes will be considered first, followed by temporary price changes.

USDA changed the manufacturing cost allowances in their pricing formulas effective October 2008. The effect of these changes reduced the Federal Order Class I price by about $0.35/cwt. and the Federal Order Class II price by about $0.26/cwt. In response to these changes, CDFA held a hearing in October 2008 that resulted in the California Class 1 price being decreased by $0.35/cwt. and the California Class 2 and 3 prices being decreased by $0.26/cwt. The change in the California prices matched the change in the Federal Order prices and became effective January 1, 2009. In essence, the California price changes endeavored to maintain the price alignment that existed prior to the Federal Order price changes.

Table 2 shows the previous price comparison for California Class 1, 2, and 3 prices and Federal Order Class I and II prices in contiguous states. As shown in Column A, prior to the changes in both California and Federal Orders, California had a competitive advantage in Class 1 prices of $0.28/cwt. over Arizona and $0.10/cwt. over Oregon, but a competitive disadvantage of $0.67/cwt. with Las Vegas. Furthermore, California also had a competitive advantage of $0.75-$1.02/cwt. in Class 2 and 3 prices. During the October 2008 hearing, the Department was concerned with maintaining the competitive advantage of these high valued classes because the Pool utilization of these classes had been decreasing over the last few decades. The Department continues to be concerned with this trend. In fact, the decrease in California prices following the October 2008 hearing in California proved to be important. As shown in Column B of Table 2, if California had not decreased its prices in response to the Federal Order price decreases, California would have lost its competitive advantage completely in Class 2 and 3 and in Class 1 prices over Las Vegas and Oregon. It is likely that this would have led to lost sales of finished products and further erosion of Pool utilization for these classes.

Table 2 - Comparison of California Class 1, 2, and 3 Prices to FMMO Class I and II Prices in Contiguous States

California Class Prices Minus FMMO Class Prices[1]

	A **Previous Alignment** Prior to California & Federal Order Changes (Feb. 07 - Sept. 08)	B **Estimated Alignment** Without California October 2008 Hearing Changes & After Federal Order October 2008 Formula Changes (Oct. 08 - Present[2])
Class 2		
Southern CA	-$0.75	+$0.48
Northern CA	-$0.98	+$0.25
Class 3		
Statewide	-$1.02	+$0.20
Class 1		
Southern CA to Arizona	-$0.28	-$0.10
Southern CA to Las Vegas	+$0.67	+$0.85
Northern CA to Oregon	-$0.10	+$0.08

[1] A negative number indicates that California processors have a competitive advantage, while on the contrary, a positive number indicates that California processors are at a competitive disadvantage.

[2] Class 1 comparison runs through November 2009 and Class 2 & 3 comparison runs through October 2009.

Table 3 shows the current price comparison for California Class 1, 2, and 3 prices and Federal Order Class I and II prices in contiguous states. As shown in Column C, following the changes in both California and Federal Orders prices, California has a competitive advantage in Class 1 prices of $0.48/cwt. over Arizona and $0.30/cwt. over Oregon, but a competitive disadvantage of $0.47/cwt. with Las Vegas. California also has a competitive advantage of $0.12/cwt. in the Class 2 price in Northern California and $0.17/cwt. in the Class 3 price, but a competitive disadvantage of $0.11/cwt. in the Class 2 price with Southern California. Comparing Column A of Table 2 with Column C of Table 3 shows that since the change in prices, California has maintained the same relative advantage in Class 1 prices since before the changes, but has noticeably lost competitiveness in the Class 2 and 3 prices.

Table 3 - Comparison of California Class 1, 2, and 3 Prices to FMMO Class I and II Prices in Contiguous States

California Class Prices Minus FMMO Class Prices[1]

	C **Current Alignment** (Jan. 09 - Present[2])	D **Estimated Alignment** Based on Alliance Proposal (Jan. 09 - Present[2])
Class 2		
Southern CA	+$0.11	+$0.37
Northern CA	-$0.12	+$0.14
Class 3		
Statewide	-$0.17	+$0.09
Class 1		
Southern CA to Arizona	-$0.48	+$0.02
Southern CA to Las Vegas	+$0.47	+$0.97
Northern CA to Oregon	-$0.30	+$0.20

[1] A negative number indicates that California processors have a competitive advantage, while on the contrary, a positive number indicates that California processors are at a competitive disadvantage.

[2] Class 1 comparison runs through November 2009 and Class 2 & 3 comparison runs through October 2009.

Column D of Table 3 shows what the estimated price alignment would be based on the current alignment plus the permanent price increases of the AWMP proposal. As shown, California would have a competitive disadvantage in all of the higher valued classes, ranging from $0.02-$0.97/cwt. in Class 1 and $0.09-$0.37/cwt. in Class 2 and 3 for the period January-November 2009 (this impact is different than Column B in Table 2 because of different time periods and input factors). If California were to completely lose its competitive edge, sales of the products made from these classes would decrease, which would cause California producer revenues from these classes to shrink. Over the last few decades, these higher value classes have become a smaller portion of the Pool. If this trend continues, the lower value classes (4a and 4b) will become an even larger portion of the Pool. In the long run, this will drive down the Pool price, which will ultimately hurt dairy producers. This was a concern during the October 2008 hearing and continues to be a concern. Because of the long-term, adverse effects to dairy producers that would be caused by the potential loss of the higher valued classes; the Panel believes a permanent price increase due to price alignment is not currently justified.

Some producer testimony argued that a permanent price change is warranted because the quantity of pooled solids in Classes 1, 2, and 3 have not increased in response to the class price decreases from the October 2008 hearing. Basic economic theory states that as the price of a good decreases, the quantity demanded of the good increases. The testimony asserted that since these class prices decreased, the quantity of the pooled solids for these classes should have increased. Department data does show that from January-September 2009, the quantity of total pooled solids of Class 1 and 3 decreased by 2.2 percent and 2.0 percent respectively, compared to the same period in 2008. These witnesses further testified that even though the total pooled solids of Class 2 did increase during the time period in question, the increasing trend actually started prior to the price decrease from the October 2008 hearing. Thus, the price decrease did not have the intended effect on pooled solids.

This conclusion is debatable. First, a review of Department data shows that during the time period in question, the quantity of total pooled solids in Class 4a and 4b also decreased. The pooled solids in Class 4a decreased by 5.3 percent. Class 4b pooled solids decreased by about 9.5 percent once pooled solids are adjusted for the decrease that occurred due to a number of producers electing to become Grade B milk producers in January 2009, which removes their production from Pool accounting. In essence, the pooled solids in these classes decreased, even though their class prices were not changed as a result of the October 2008 hearing. Second, there were probably other factors that influenced the decline in pooled solids during 2009. For example, domestic and global recession caused a decline in the demand for finished dairy products, which would have caused a decline in pooled solids. Also, the reduction in milk supplies caused by the extreme financial conditions facing dairy producers throughout 2009 could have also influenced the decline in pooled solids. Ultimately, it is difficult to disentangle the effects of class price decreases following the October 2008 hearing from the effects of recession and milk production decreases, or any other factors that could have influenced pooled solids. The argument of decreased pooled solids in 2009 does not sustain the conclusion that a permanent price increase is necessary or appropriate.

As discussed previously, there are a number of market uncertainties that have the potential of having significant impact on the future of the California dairy industry. These include:

- Throughout 2009, CWT has taken steps to intervene in dairy markets. CWT is in the process of completing another herd retirement round that will remove cows and milk production. This action has not yet been finalized. The effect of this herd retirement on the California and national markets is still unclear.
- USDA's intervention into the nation's dairy market and the recently passed 2010 Agricultural Appropriations Bill, with its $60 million allotted for the purchase of cheese to be used for food banks and nutrition programs and $290 million allotted for direct payments to dairy farmers, has yet to be implemented.
- The European Union's recent downward adjustments of their export subsidies will continue to influence domestic and global dairy markets.

In essence, milk production and dairy commodity markets will be influenced in the near term by all of these actions. However, since the full effect of these market intervention actions is not yet observable, it is difficult to predict what will occur in the near future both in California and in the nation. Changes in the pricing formulas as a result of this hearing will take effect at more or less the same time as these market intervention actions.

Any hearing decision that would implement permanent increases in California's prices at this time will increase the risks of miscalculating how those uncertainties play out. A wrong decision could cause long term damage to California. It is reasonable to take appropriate action to avoid making a critical miscalculation at this point in time. There will be time in the future to consider appropriate permanent pricing changes when the impact of those uncertainties is better understood.

The California dairy industry has experienced some marked changes that do merit discussion. California milk production has declined dramatically in the last year and has corrected the milk supply imbalance that caused the previous processing capacity issues. Department data show that California milk production has declined every month from October 2008 to September 2009, when compared with the same month in the previous year. Although milk production decreased slightly for six months in 2003 compared to the previous year, the magnitude and duration of the current decreasing trend has not been observed since 1978-79. The current milk production decrease is a major departure from the long term, increasing production trend the California industry has experienced for various decades now. It appears this current trend of decreasing milk production will continue for a least a few more months. Further, Department data and anecdotal evidence does confirm that the state currently has processing capacity not being fully utilized and processors have recently had some difficulties in procuring sufficient milk supplies to match their business needs.

During the October 2008 hearing, the Hearing Panel had expressed concerns about the loss of Class 1 sales to a Nevada fluid milk processing plant. The out-of-state processor had gained market share because of its access to surplus California milk supplies that could be procured below regulated Class 1 prices which provided the opportunity for the firm to sell below the finished prices of most California fluid products. However, California no longer has excess milk supplies and the spread between the Class 1 and overbase prices diminished in 2009, which removed the advantage the Nevada processor enjoyed. The concern of this Nevada fluid milk processor has diminished greatly, although this concern could resurface if excess milk supplies and the advantageous margin were to return in the future.

Considering the historical precedence of previous hearings called on an emergency basis and taking into account the changes in the California dairy industry and the reasons cited for not making permanent changes in the pricing formulas, a temporary price change is appropriate and warranted. The hearing record shows that producers, processors, and representatives of other business sectors associated with the dairy industry all acknowledge that 2009 has been a financially difficult year for dairy producers. Department data and anecdotal evidence strongly corroborate this assertion. The hearing record also shows that both producer and processor representatives testified that dairy producers warranted some kind of price relief in the face of their financial difficulties. The Panel agrees that providing price relief has merit, but it should be temporary in nature. The relief will aid some dairy producers to “weather the financial storm” until their situation improves, but it will not be large enough to recoup all of the financial losses from the past year.

When reviewing the temporary proposals, time periods of three, six, and twelve months were presented. Because of the uncertainty of the near future and the cyclical nature of dairy markets, a six or twelve month period of time is too long. The markets for dairy commodities tend to move relatively quickly and can change in a matter of days or weeks. The markets for finished products, such as fluid milk can require processors to make bids for sales contracts on a monthly basis. The markets for finished dairy products are quite dynamic. As a result, most processors supported the DI concept of a 3-month time period.

Panel Recommendation
The Panel recommends a temporary price increase for a period of 3 months, from January 2009 to March 2009.

<u>Which Class Prices to Increase for Relief</u>

There was sharp debate and contrast in the testimony of the hearing witnesses over the manner in which income relief should be generated. WUD, the AWMP, and the DI proposed non-structural changes that garnered differing levels of support and opposition. The AWMP proposed increases to only Class 1, 2, and 3, which received wide support from both marketing and processing producer organizations (WUD, MPC, CDI, and LOL). On the other hand, this proposal was opposed by processing organizations (DI, Kroger, SSI, Kraft, and Leprino). The DI proposed increases on all classes of milk, which was generally supported by processing organizations (Kroger, SSI, Unified Grocers, Kraft, and Leprino), but opposed by some producer organizations (CDI and the AWMP). Even though WUD originally petitioned for increases on all classes of milk and then modified its position at the hearing, MPC still supported the concept in their testimony. Some Class 3 and 4b processors (Nestlé, Farmdale, Saputo, and Hilmar) opposed making any changes to any of the classes.

Much of the testimony argued that the marketing conditions of high valued products from Class 1, 2, and 3 differed from the manufacturing classes of Class 4a and 4b. The AWMP testified that there is a difference in the approach to pricing among the classes. Following their testimony, by knowing ahead of time what one’s competitors are paying for milk, a Class 1, 2 or 3 processor is better positioned to weather a price increase. While the Panel does not disagree with this difference, the Panel believes that Class 1, 2 and 3 processors would still need to absorb the cost of a price increase just like Class 4a and 4b processors. Despite the difference in the pricing formula structure, Class 1, 2 and 3 processors would still need to remain competitive with the neighboring states and may not necessarily be able to pass along the price increase to the marketplace. The price increase may be partial or completely absorbed as losses due to competitive pressures.

Moreover, Class 1, 2 and 3 only represent a small percentage of total Pool utilization (approximately 25 percent). In order to provide the needed relief to producers who receive blended Pool prices, the required increase to be imposed on those classes would need to be relatively large to make a difference. However, by including Class 4a and 4b, the resulting increase to the blended Pool prices is larger. In order to provide the highest level of relief possible without upsetting the competitive situation too greatly, including Classes 4a and 4b is warranted.

Class 4a and 4b are market-clearing classes. Therefore, impacting these plants with higher minimum prices will pose some added risk. One major concern is that it is difficult to pass on increased raw product costs to buyers of manufacturing products. The Panel recognizes that there is validity to this argument, but also realizes that all processors will be adversely affected during the duration of the increase, regardless of the finished product produced. Because all processors will be affected adversely regardless of class, the increase should be spread among all the classes.

Processing producer cooperatives opposed temporary changes in Class 4a and 4b prices because of the redistribution of revenue from their producer members to producers that are not members of processing cooperatives. In essence, higher prices in these classes will increase the Pool price to all producers, but the increased raw product costs associated with such an increase would be passed on to producer members of the processing cooperative. While this argument is true and the result is difficult to avoid, the Panel is cognizant that an appropriate increase in the higher valued classes will increase the Pool price to all producers including member producers of processing cooperatives.

Class 4a and 4b plants are the most likely to lack milk supply in the current situation where milk production keeps falling. The Panel is concerned by the negative impact a further decline in the state's milk production could have on Class 4a and 4b plants. Insufficient quantities of milk reduce efficiencies within a plant and can cause per pound processing costs to rise. Such an increase in costs due to reduced milk supplies could be highly detrimental to a plant's investment. The decrease in California's milk supply may put Class 4a and 4b plants at risk. As a result of this risk, these classes should bear some of the burden of a temporary price relief.

Panel Recommendation
The Panel recommends a temporary price increase across all classes of milk.

Magnitude of Class Price Changes

Different price increase levels were suggested in the proposals and testimony. The AWMP proposed an increase on the Class 1, 2 and 3 price formulas of \$0.50/cwt., \$0.26/cwt. and \$0.26/cwt. respectively. The WUD petition requested a \$0.50/cwt. increase on all five classes. The DI proposed a \$0.20/cwt. increase on all five classes, with a trigger that nulls the price increase if either the Class 4a or 4b goes above \$13.00/cwt. These differing class price increases would result in a Pool price increase of \$0.11/cwt., \$0.51/cwt. and \$0.20/cwt. (if the trigger was not activated) respectively for the AWMP, WUD and the DI.

When considering a price increase to provide relief for producers, it is important to balance class price increases with competitive alignment associated with the class price relationship with neighboring states. Price increases that are too high, even on a temporary basis, can jeopardize that relationship and put California products at too large of a competitive disadvantage. This could decrease California's ability to sell their products and decrease their market share. As sales are lost, processors would reduce their milk supply procurement, which is detrimental to producers. Ultimately, the class price increase needs to balance the competitive situation of the specific finished products produced within the class and the need to provide price relief to dairy producers. During the 1980s and 1990s, compared to plant costs, the manufacturing cost allowances in the pricing formulas were relatively more generous than current levels in order to facilitate the expansion of processing capacity in the state. As a result, the Department had more latitude at those times to provide higher temporary price relief because of the advantage that existed with the higher manufacturing cost allowances. However, this latitude no longer exists with the current pricing formulas, which makes the issue of competitive alignment a greater current concern. Therefore, because of the differing marketing conditions associated with the products of the differing classes, each class warrants individual consideration with regards to competitive alignment.

The fluid milk products of Class 1 tend to be distributed and sold regionally. Competition of California processors tends to be located in California's contiguous states. Since the price alignment of this class is reasonable and fluid milk processor testimony suggested they could endure a temporary price increase of modest magnitude for three months, this sector of the dairy industry will not be placed in jeopardy by an increase. The proposed temporary Class 1 price increases ranged between the $0.20/cwt. proposed by the DI and the $0.50/cwt. petitioned by WUD.

The WUD petition proposed a $0.50/cwt. increase on Class 2 and 3, while the DI and the AWMP proposals called for increases of $0.20/cwt. and $0.26/cwt. respectively. Based on Table 3 the price alignment for these classes are reasonable, even though the competitive position of California processors has eroded some since the October 2008 hearing. These classes are the smallest based on Pool utilization and their share of the Pool has been decreasing over the last few decades. The Panel was concerned about these shrinking classes of milk during the October 2008 hearing and this concern continues. Nestlé opposed any changes and Farmdale testified that "$0.50/cwt. translates to roughly $0.16/32 lb. tub of sour cream in Class 2, or around one percent price adjustment in the finished product. Our margins in that product class are probably able to absorb that kind of increase in the short term." The ability to absorb a temporary increase was mixed in the testimony.

Even though the competitive situation for Class 2 and 3 products appears adequate for California processors, the concern exists that some Class 2 products are being shipped into California from a processor in Texas that has also completed a new plant in Arizona, which is closer to the California market. Based on Department data, a temporary increase in Class 2 and 3 should be reasonably absorbed by processors. However, the magnitude of this change should be smaller than the Class 1 change, somewhere in the range close to the AWMP and the DI proposals.

As previously noted, the Class 4a and 4b prices must be market-clearing prices. These products are sold regionally, domestically, and globally. Because these classes make up such a large portion of the Pool based on utilization, it is important to be price competitive in the market for these products. Based on the Department's Manufacturing Cost Exhibit for the costs of calendar year 2008 (released in October 2009), the volume covered of butter, powder, and Cheddar cheese by the current manufacturing cost allowances are approximately 54 percent, 56 percent, and 5 percent respectively. This data indicate that the processors of these products are in the worst competitive position, relatively speaking, when compared to the other classes. As a result, processors of these products do not appear to be able to absorb the same magnitude of class price increase as the other classes and the temporary change to these classes will need to be minimal. The Panel recognizes that making temporary changes to the Class 4a and 4b formulas will negatively impact the effective volume covered by the manufacturing cost allowances for January-March 2010. Undoubtedly these issues will be addressed in the future when they can be more thoroughly reviewed and considered in the normal hearing process.

The Panel examined a number of price scenarios across all classes of milk. It used the following criteria as means to narrow down its recommendation. For the three months that the temporary price adjustment would be in effect, various pricing changes were examined:

- To maximize total revenues to producers by spreading the added revenues across all class prices.
- To minimize the frequency of occurrences that California dairy products were uncompetitive in price with competing products from outside California
- To estimate each class' individual added revenues associated with the temporary price increases.
- To estimate the percentage of total revenues derived from each class price adjustment.
- To estimate the increase per classified price on both consumer sizes as well as per hundredweight of each price adjustment.
- To achieve a close balance between the added total revenues that are derived from combined Class 1, 2, and 3 usage versus the combined added revenues from Class 4a and 4b usage.
- To minimize the negative consequence on California cooperative producers who had invested in manufacturing facilities.

In determining an appropriate temporary price increase recommendation, the Panel is cognizant that commodity prices are slowly inching up and producer income will be rising with it. Given the major discrepancy between the cost of producing milk and the revenues from milk produced that dairy producers have faced in the last year, the Panel believes it is critical to provide supplemental temporary aid to help dairy producers "weather the financial storm." The DI proposal to put in place a trigger mechanism that would implement their price increase only if both Class 4a and 4b were below $13/cwt. could prevent a price increase from being implemented. Because of the grave losses suffered by producers and the subsequent decline in milk production, a temporary price increase without a trigger mechanism is more appropriate.

Finally, both the WUD and the DI proposals for class price changes distribute the increase across the different components in a similar fashion. Although the class price increases proposed by these organizations differ, the proposals do distribute the increases to the components using similar ratios. Since the testimony in the hearing record was silent on how to distribute the proposed class price increases to each component, the Panel is inclined to recommend class price increases in a manner that distributes the increase across the components in the same proportions as proposed by WUD and the DI.

Panel Recommendation

The Panel recommends a temporary price increase of $0.35/cwt. on Class 1; $0.25/cwt. on Class 2 and 3; and $0.10/cwt. on Class 4a and 4b for the pricing period January 2010 through March 2010.

This Hearing Panel Report has been prepared and submitted by:

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Appendix A

Summary and Price Effects of the Panel Recommendations

Panel Recommendations

- Not to include the Cost of Production in the Class 1, 2, 3, 4a, and 4b pricing formulas.
- No changes to the Class 4a and 4b manufacturing cost allowances and f.o.b. adjusters.
- No changes to the whey factor in the Class 4b pricing formula.
- No change to the NFDM pricing series used in the Class 1 and Class 4a pricing formulas.
- Not to establish a price floor on the Class 4a and 4b pricing formulas.
- Implement a 3-month temporary price increase of $0.35/cwt. on Class 1 (equivalent to 3¢ per gallon of whole milk); $0.25/cwt. on Class 2 and 3; and $0.10/cwt. on Class 4a and 4b for the pricing period January 2010 through March 2010.
- The temporary price increase will create additional revenues of nearly $15 million to the Pool for the three-month period.
- The temporary price increase will raise the Pool price by $0.155/cwt.
- The temporary formula changes will be implemented as follows:

Class 1:	Fat:	$0.0035 per pound
	SNF:	$0.0298 per pound
	Fluid:	$0.0009 per pound
Class 2, 3:	Fat:	$0.0205 per pound
	SNF:	$0.0205 per pound
Class 4a, 4b:	Fat:	$0.0082 per pound
	SNF:	$0.0082 per pound

Appendix B

SUMMARY OF TESTIMONY AND POST-HEARING BRIEFS

ALLIANCE OF WESTERN MILK PRODUCERS, William Van Dam

Testimony

- Milk production has decreased since July, it is not an aberration
- Production bases are no longer the factor that is constraining production
- Dairy producers are experiencing losses far greater than ever before
- The differences between Class 1 prices and surrounding states are equal to the reduction in California Class 1 prices that were implemented as a result from the October 2008 hearing
- You can increase the California Class 1 price by $0.50/cwt. without encouraging milk to move into California
- Proposes to restore the $0.26/cwt. to Class 2 and 3 that existed prior to the October 2008 hearing
- Conditions are different this year compared to last year: production costs running at historic levels, milk prices have dropped dramatically
- Processing capacity is not an issue any more
- Oppose any changes in the Class 4a and 4b price levels
- Does not support the proposals by the DI, MPC, CDC or CDWA

Post Hearing Brief

- Feels that the 4a plants will be most affected by the decline in the milk supply- reduced volume to process which will negatively impact costs, any surcharges they will have to pay and no adjustment to the manufacturing cost allowances forcing producer owners to absorb the costs
- While there was too much complex material being considered at an emergency shortened time frame hearing, complex issues were invited in the hearing announcement
- The original petition clearly requested a permanent change, if only temporary changes were to be considered, the call of the hearing should have stated that or the hearing should have been denied

WESTERN UNITED DAIRYMEN, Michael Marsh and Tiffany LaMendola

- Summary of political actions taken by WUD over the past year
- WUD withdraws its petition on all classes of milk
- Instead supports the AWMP petition
- Does not want to financially harm coops
- California milk production has reduced dramatically
- Dairy producers are in need of financial assistance
- Surplus production is no longer available to supply out-of-state processors
- Northern Nevada's Class 1 price was re-aligned with Northern California prices as of February 2009
- California Class 1 sales figures are up
- Spread between Class 1 and the overbase price has declined
- The modest proposed increase proposed by the AWMP should not leave California at a major competitive disadvantage
- Took no position on the DI, CDWA, CDC, or MPC proposals

Post Hearing Brief

- Pros to past decisions to temporarily increase class prices; infusion of money at a time of dire need, temporary changes should not cause market disruptions, could increase milk supplies to ease shortages
- Cons to past decisions to temporarily increase class prices; processors are forced to pay an extra artificial amount, competitive disadvantages could occur, processors may be required to pass along the costs to producers through assessments or reduced premiums
- Neutral position on CDC, CDWA and MPC was due to need for further discussion and review before taking a position
- Data and graphs on EU dairy subsidies outline that EU export subsidies have been reduced from levels in place earlier in the year
- Data provided on export refunds provided by the EU

MILK PRODUCERS COUNCIL, Geoffrey Vanden Heuvel

- Past policy of increasing manufacturing cost allowances to increase plant capacity is no longer the situation in California
- Producers have lost hundreds of millions of dollars in equity over the past twelve months, unlike ever before
- Proposes the use of the NASS NFDM price in the Class 4a and Class 1 formulas
- The difference between the two price series, the inclusion of long term contracts by CWAP when prices were rising, resulted in a loss of more that $200 million to California dairy producers
- More than 95 percent of the CWAP comes from two cooperatives that jointly market their powder through a single marketing agency in common
- These two coops are insulated from market forces, whatever they decide to sell their powder for becomes the product value price that determines the milk price they are subjected to
- Inadequacies of CWAP caused huge losses to producers –including long term contracts in CWAP
- Adjust the calculation of the whey solids value in the Class 4b and Class 1 formulas
- Replace the Dairy Market News dry whey price with the NASS survey dry whey value price
- Stay with the fixed $0.25/cwt. value and when the NASS dry whey value exceeds $0.35/lb., add one half of the value to the Class 4b formula
- Cites Section 62062 as reason for adopting the proposal
- Supports the AWMP proposal and were prepared to support WUD’s proposal

Post Hearing Brief

- Stresses that the call of he hearing was to consider temporary and permanent changes and that there are no special rules for emergency hearings, thus all proposals should be considered
- MPC’S issues are not new and should not be ignored because they are not emergency in nature
- Tom Wegner’s testimony stating that producers are being treated unfairly by utilizing the CWAP price series further strengthens MPC points
- Do not wait for consensus of the industry, move now from CWAP to NASS to eliminate the millions of dollars that dairy producers will likely lose in the future
- This proposal is urgent and timely

- The marketing federation failed to explain when asked why the reporting of lagging sales at lower prices affected the CWAP in 2007, while their reporting of lagging sales at higher prices did not affect CWAP sales in 2008
- Because the Federal Orders use a variable whey factor and California uses a fixed whey factor there is danger of falling significantly out of alignment with producers that operate in Federal Order areas
- California cheese makers need to work with producers to come to a compromise on the value of whey in the pricing formula
- Does not feel that a \$0.20-\$0.50/cwt. of milk increase will decrease milk sales
- Response to a Panel question “Is auditing of NASS reports being performed ?”, the answer is yes they are conducted by the regional market administrator’s office nearest to where the plant is located and that procedures and policies have been developed

DAIRY INSTITUTE, William Schiek

- Acknowledges that producers are facing challenging times and suffering large losses over the past twelve months
- Market prices are true economic signals and the regulated pricing system must respect them
- Regulated prices should be the minimum price that stabilizes the market and allows the market to set the actual price
- Government actions to overrule market-driven price movements are bad policy and harmful
- Any form of financial assistance to producers should not disadvantage in-state processors competitiveness
- Real relief for produces must come from the market
- Price relief from increases to regulated prices risk hurting the industry’s market opportunities
- Does not favor structural changes due to the expedited hearing time frame, not enough time to properly and fully evaluate structural changes
- Proposes for a three-month increase of \$0.20/cwt. on all milk with a trigger to only implement if both the 4a and 4b milk prices in the second prior month do not exceed \$13.00/cwt.
- Oppose the AWMP proposal due to it being permanent in nature
- Feels that emergency in nature does not lend itself to permanent changes
- If the AWMP proposal is implemented it will put California processors at a competitive disadvantage with regards to fluid milk
- Does not support the level and length of time in the WUD proposal
- Does not support CDI’s proposal, feels needs more analysis and review than can be given in this short time frame
- Does not support the CDC and MPC proposals because it is structural in nature and there was limited time frame for analysis
- Does not support the CDWA proposal, would ultimately lower producer revenue

<u>**Post Hearing Brief**</u>

- California plants must remain competitive- increasing regulated prices negatively impacts sales of dairy products
- Price changes in Class 1, 2 and 3 are passed on to consumers
- Out-of-state sales will be especially vulnerable to increases in the California regulated milk price

- California is not on equal footing with other states when it comes to the cost of doing business- energy, labor, tax and regulatory costs in California are higher than in many other western states
- When government sets prices that are not supported by market fundamentals, the wrong signals are sent to the industry and producers are ultimately harmed
- Price recovery is already occurring-market prices are moving up
- Believes there is no economic justification for a permanent increase or for a large temporary one

CALIFORNIA DAIRY CAMPAIGN, Lynn McBride

- Dairy producers are in serious financial jeopardy, many filing for bankruptcy
- Many processors reported strong profits this past year
- Proposes incorporating producers cost of production (from the statewide cost comparison survey) into the Class 1 formula
- Proposes using the higher of the Commodity Reference Price or the cost of production to establish a price floor that will prevent Class 1 from dropping below the cost of production
- Proposes adjusting the 4a and 4b formulas to establish a variable manufacturing cost allowance that would move up and down depending on the relationship between the cost of production and the end product values form the Commodity Reference Price
- Proposes including the higher of the commodity prices or the USDA support price in the pricing formulas to prevent minimum prices from dropping below the federal support price
- Between 80 and 90 percent of dairies in the last quarter of 2008 and into 2009 were operating at a net loss in excess of $5.00/cwt.
- Supports any proposals that increase producer prices
- Does not support the CDI proposal
- Feels the DI proposal should have a trigger closer to the actual cost of production, which is over $15.00/cwt.

Post Hearing Brief

- Expressed concern regarding questioning from the Panel at the hearing being confrontational and aggressive

CALIFORNIA DAIRY WOMEN ASSOCIATION, Linda Lopes

- Dairy producers are facing tremendous financial difficulties, not being able to pay their bills
- Supports a pricing system that reflects the cost of producing milk
- Proposes revising the pricing formulas to reflect the cost of cost of production with a 2009 production base in the Classes 1, 2, 3, 4a, and 4b formulas for twelve months
- Proposes this revision in pricing due to production costs exceeding prices by 50 percent
- This proposal would help stabilize the California milk industry
- Feels that the AWMP and WUD proposals do not ask for a sufficient amount of price increase, but is better than nothing
- Does not support the CDI proposal
- Dairy producers need a cost of production to survive

Post Hearing Brief

- The extreme losses as outlined by the two CPA firms cannot be ignored
- Processors do not want to increase the price, they will if CDFA increase the price
- Our proposal is temporary, we do not want to make record profits, just give some confidence to our banks and creditors
- Consider the impact of low prices on our employees, vendors and the consumers
- Submitted approximately forty letters from creditors, vendors and other dairy producers supporting an increase in the price to dairy producers

CALFIORNIA DAIRIES INC., Eric Erba

- Supports the proposal by the AWMP
- CDI did not intend to propose changes to the 4a pricing formula, but only did so due to the expanded call of the hearing- considering all temporary and permanent changes to all classes of milk
- Recognizes the lack of time to perform analysis and input on the proposed change
- Appreciates that WUD no longer supports their proposal
- Does not support any increase in the 4a price because nearly all the butter and powder plants are owned by producers, and an increase in 4a merely redistributes money from producers who have made investments in processing facilities to those who have not
- Opposes any changes to the 4a formula, but If any changes to increase the 4a price are made, proposes a cost-justified increase in the manufacturing cost allowances for butter and NFDM and the f.o.b. adjuster for butter
- Opposes the adopting of the NASS NFDM price series for the CWAP
- Does not support CDC, CDWA or the DI

Post Hearing Brief

- NASS vs CWAP issue has already been asked and answered
- Cannot increase Class 4a and 4b prices, they are market clearing prices and must compete in national and international markets where price is a dominant consideration for buyers
- More than 75 percent of the milk processed in California is in Class 4, thus trying to extract any increase from the market would have a potential devastating consequence
- Past emergency relief granted at hearings has had minimal if any impact on Class 4 prices
- The hearing notice called for both temporary and permanent proposals

HILMAR CHEESE COMPANY, John Jeter

- The past twelve months have been a very difficult time for the dairy industry, producers have born the brunt of the price risk
- Support market driven, higher prices that reward those who are in the supply chain earning it
- Oppose changes to the system that perpetuate further income redistribution within the Pool and give more money to those not directly contributing to the production of higher value products
- Oppose all proposals
- Does not support any change to the minimum price
- Do not reward those producing the lowest value products

THE KROGER Company, John Hitchell

- Supports the DI proposal
- Recognizes that dairy producers have suffered and that it has led to a reduction in the supply of milk
- Opposes proposals from the AWMP and WUD
- Opposes any increase in producer income longer than three months

GENSKE, MULDER AND CO, Pete Hoekstra

- Dairy producers are in a financial crisis
- Only one dairy they have as clients made money, an organic dairy
- Break even numbers for dairies is $15-$16/cwt.

LAND O'LAKES, INC., Tom Wegner

- Supports the proposal by the AWMP
- California's dairy farmers have experienced miserable financial conditions
- Supply and demand conditions have changed since 2008, 4a and 4b plants are having difficulty acquiring milk and plant expansions have continued
- Class 1 prices are lower than in neighboring states
- Neutral to MPC's proposal- have a number of concerns about it and feels that more time is required to fully analyze and formulate positions around the whey concept
- Opposes the CDWA proposal, gives less money to dairymen
- Opposes the CDC proposal, again not enough time to fully analyze

<u>Post Hearing Brief</u>

- Corrects the written statement on page 2, paragraph five of the LOL testimony to read: *The average overbase price for the 12-month period October 2008 through September 2009 <u>($11.02</u>/cwt.) compared to the average overbase price October 2007 through September 2008 <u>($17.41/</u>cwt.) decreased by $6.39/cwt. representing a 36.7 percent decrease. This is just another indication of how bad things are for California dairymen.*
- Would LOL support a temporary increase in class prices, yes they would and would even support a six month implementation of the AWMP proposal and a continuation of the AWMP proposal if the increase did not negatively impact California's competitive relationship

SUPER STORE INDUSTRIES, Dennis Brimhall

- Supports the DI proposal
- Opposes the AWMP, CDWA and CDC proposals
- WUD proposal, has merit but for a more modest and temporary level

SAPUTO CHEESE USA INC., Greg Dryer

- The economic situation for dairy is global in scale
- Proposes to leave the system alone
- The market led us into this crisis and the market will lead us out
- Opposes any changes to the pricing formula

UNIFIED GROCERS, John Bedrosian

- Supports the DI proposal
- Let the market work
- Opposes any significant structural changes

FARMDALE CREAMERY, Scott Hofferber

- Opposes any changes to the pricing formulas
- Knowing the producer crisis, have put off calling for a manufacturing cost allowance hearing
- Agrees that the manufacturing cost allowance issue would be better dealt with in a standard hearing process
- Feels adjustments to the formulas benefit producer-owned processors as it shifts economic value from one income statement to another, whereas proprietary processors bear a drain on their income statement and have to go to the market for the offset
- Emergency is in its end stages thus, opposes the AWMP, the DI, CDC and CDWA proposals
- Opposes MPC'S and WUD'S proposals

KRAFT FOODS, Michael McCully

- Opposes the AWMP, WUD, CDC, CDWA proposals and the 4b portion of the MPC proposal
- Supports DI proposal but has some policy concerns about it
- Need to focus on long term solutions as opposed to short-term fixes as outlined in these hearings
- Our current systems (California and Federal Orders) are outdated regulatory systems that hold back the dairy industry from realizing the full potential and opportunities
- The proposals at the hearing attempt to force the Department to regulate THE price instead of the minimum price

NESTLE USA AND DRYERS GRAND ICE CREAM HOLDINGS, INC., Patricia Stroup

- Opposes any increase to the regulated minimum price for any class of milk
- The regulated price is the minimum price not the *total* price
- Is sympathetic to dairy producers situation
- Feels nothing has changed in the relationship between the California Class prices and the Federal Order system to warrant a price change
- Surcharges imposed increase uncertainty and reduce the willingness to produce and invest in California
- Increases in price have an effect on consumers buying power in tough economic conditions, such as we are facing currently

JOHN ROSSI HAY, John Rossi

- Noted that many dairy producers that were in bankruptcy court, but most of them were thrown out of court because they could not show repayment plans
- Commends processors for staying in business
- Carries paper on hay purchases so dairy producers can stay in business
- Producers need more than the $0.50/cwt. in the proposals
- Urges the Panel to save dairy producers and floor the price at $14.50/cwt.
- Need a tariff on imports into California

A. L. GILBERT FEED COMPANY, David Gilbert

- Producers do not have equity left to borrow money
- When dairy producers are in financial ruin, they cannot pay their bills

- A. L. Gilbert has fired forty employees in the past year to survive
- Do what you can to support dairy producers

LEPRINO FOODS COMPANY, Sue Taylor

- Supports the DI proposal, not because it sets good policy, but with the pragmatic belief that the Department is committed to enhancing producer prices
- Opposes the AWMP, WUD, MPC, CDI, CDC and CDWA proposals
- Recognizes the extreme producer stress in these tough economic times
- Believes that the market will provide relief