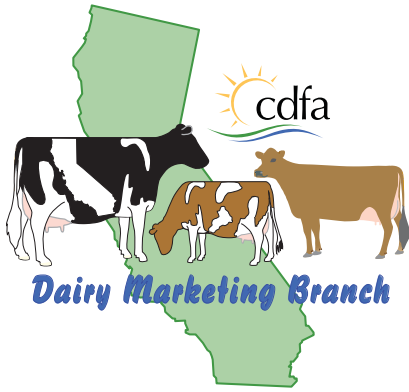


2008 Whey Review Committee Report



California

Dairy Review

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California Whey Review Committee Completes Analysis of Class 4b Whey Factor Options

Last December, Secretary Kawamura appointed a Committee of 14 dairy industry members to review the whey factor used in the formula to establish the minimum Class 4b (milk used to make cheese and dry products) farm milk price. The Committee was comprised of seven producer representatives and seven processor representatives.

At the first meeting held December 28, 2007, Secretary Kawamura addressed the California Department of Food and Agriculture's (Department) goal in establishing the Class 4b price formula. He explained that the Department was searching for a long-term method that was market-based and would signal a proper value for whey that allows both California producers and processors to earn a favorable return from their investments and enterprise. Secretary Kawamura encouraged the Committee to focus on long term planning. Department staff was made available to assist the Committee in their work and a professional facilitator, Dr. Jim Morgan was also provided.

Committee Mission and Ground Rules

The Committee refined their mission at the December 28, 2007, meeting. Undersecretary George Gomes urged the Committee to look at all opportunities and options so that producers and processors can compete in a global marketplace. After discussion, the Committee set

an initial goal to provide a recommendation to Secretary Kawamura by the end of March 2008 on whey pricing within the context of the current Class 4b pricing formula

... the Committee must look at all opportunities and options so that producers and processors can compete in a global marketplace.

and its structure. They also agreed to work to achieve a common understanding of producers' and processors' costs and issues and left open the option to make recommendations on other pricing areas. The Committee established working ground rules and set meeting dates in February and March. The Committee discussed information provided by Department staff on:

- 1) Make Allowances (historical)
- 2) Manufacturing cost data from 1982 to current for butter, nonfat dry milk, Cheddar cheese and dry whey
- 3) Whey Protein Concentrate (WPC) and Whey Protein Isolate (WPI) manufacturing cost data (if available)
- 4) Whey Protein content levels in whey products produced in California
- 5) How CDFA estimated the statistic used in the recent Hearing Panel Report that states approximately 30% of whey solids are not recovered.

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Dr. Morgan presented information as reported in the California Milk Advisory Board sponsored McKinsey Report (part 2):

- 1) California's share of the nation's cheese production jumped from 5% in 1980 to 21% in 2004 due in part to lower cheese milk prices compared to federal systems;
- 2) California milk production continues to grow faster than the growth in dairy end product demand.

Dr. Morgan led the Committee through a discussion about assumptions or beliefs that both producers and processors might have in regards to the whey issue. Each member provided at least one comment from the perspective of a producer and one from a processor. During the discussions, Committee members were asked "what else do we need to know" in order for the Committee to perform its task. Dr. Morgan captured this information and opportunity was given for comments from the public.

Information Gathering and Analysis

At the second meeting on February 4, 2008, Dr. Morgan recapped activities since the December meeting such as homework assignments and he restated the goal of

Committee Members

Producer Representatives

Scott Magneson
Tony Mendes
Ray Souza
Sietse (Sean) Tollenaar
William C. Van Dam
Geoffrey Vanden Heuvel
Tom Wegner

Processor Representatives

Andrew Branagh
Scott Hofferber
John Jeter
Mike McCully
Joe Paris
Bill Schiek
Sue Taylor

... a balance of profitability for both producers and processors is important for a strong dairy industry.

the Committee. Since the December meeting, members submitted their preferences of their top items from the "Need to Know (Facts)," "Producer Assumptions," and "Processor Assumptions" listings. From the discussions, three teams were created (each composed of a mix of producers and processors). The teams developed whey alternatives and options. Members identified issues of importance by a voting process. The top two issues were:

1. Is there an acceptable price series that tracks WPC34, WPC80 and Whey Isolates? Is the Dairy Market News Dry Whey price report an acceptable price series? Is there another plausible Dry Whey price available? Could the Department create a useful price series?
2. What are the underlying principles needed to guide a successful end-product pricing system?

The following guiding principles were identified by the Committee for their work:

- 1) The base price is established upon a common denominator for a product group;
- 2) The base price reveals market value for milk;
- 3) The underlying value of milk will rise and fall with the end product value;
- 4) A regulated system should not put a group of plants at a disadvantage beyond what would happen in an unregulated market;
- 5) A regulated system should not discourage investment beyond what would happen in an unregulated market;
- 6) Producers and processors should receive a share of market value;
- 7) The system should adhere to California laws and regulations.

The teams were next asked to develop alternatives to better address the whey pricing issue.

At the March 11, 2008 meeting, the teams presented their alternatives numbered 1 through 8. The Department supplemented the discussion with analysis of impacts of the alternatives.

Committee members asked the Department for additional analysis and information related to the eight alternatives to be presented at the March 27, 2008 Meeting. Each member was asked to rank their preferences from all of the alternatives with the exception

of #4. Alternative #4 was a major redesign of the current milk pricing system that would require new legislation to implement so it was not priority ranked.

Evaluation Criteria of Alternatives (excluding #4)

The Committee determined that alternative #4 was outside the intent and objective on which the Committee was established. While the Committee needed to focus its attention toward the alternatives that were within the Committee's mandate, the Committee felt that this alternative should be referenced in the Committee report and not simply discarded. The Committee discussed the 'status quo' option which could also be evaluated and ranked since 'no change' is also an option.

At the March 27, 2008 meeting, Dr. Morgan asked each member to identify their top three evaluation criteria when ranking the alternatives (excluding #4). Mr. Morgan then documented each member's top choice of evaluation criteria. Other evaluation criteria were also added. Some of the evaluation criteria developed included: solve the inversion problem; encourage investment in innovation, markets, and products; sharing of the risk; and be more adaptable to market driven signals. Many of these evaluation criteria mirror the guiding principles as identified by the Committee for their work at the February 4th meeting. Additional pros/cons were provided by members to the various alternatives.

Review of Top 3 Alternatives

Alternatives 1, 5, and 8 received the most positive responses and votes by the members. Dr. Morgan then asked for all WRC members to re-rank all of the alternatives (excluding #4) to ensure that no changes had occurred in the top three rankings. The top three alternatives were still 1, 5, and 8. It was noted that alternatives 1, 5, and 8, could be changed via the hearing process; but alternative #4 would require legislation. The Committee decided by a vote of 10 of the 13 members present that alternative #4 should be submitted as a separate recommendation.

Below is a brief description of the three options (1, 5, and 8), as well as option 4.

Option 1: Class 4b formula would contain a whey factor that would involve sharing of whey revenues between producer and processors, but the contribution of the whey factor to the Class 4b price would be floored at zero and capped at around \$0.55 per cwt.

Option 5: The whey factor in the 4b formula would consist of a fixed factor of \$0.18/cwt. plus an additional amount equal to the NASS dry whey price minus \$0.36 times 5.8 (yield) times .33 (share rate). The additional amount cannot be a negative number.

Option 8: End-product formula with the following features: The base value used shall be the lower of: 1. the average of the western mostly quote for dry whey as reported by DMN, or 2. 38% of the average of the central and west mostly quote for whey protein concentrate 34% as reported by DMN.

Option 4: To create the opportunity for competition for producer milk between the current regulated system and a new unregulated system.

"I recognize the challenge of increasing input costs in the dairy business and not being able to fully recover all those increases."

— Secretary A.G. Kawamura

Various changes and modifications were proposed to some alternatives to attempt to achieve consensus but it could not be reached. The Committee set one final meeting for July 17, 2008 to see if further agreement could be achieved for recommendation to the Secretary. The Committee was asked to review the three alternatives over the next few months and share them with constituency groups.

At the July 17th meeting, Secretary Kawamura said "I recognize the challenge of increasing input costs in the dairy business and not being able to fully recover all those increases." He noted the same condition is challenging many commodities, not just dairy. He reaffirmed his support to ensure the profitability of both producers and processors and thanked the members for their diligent efforts on the Committee.

Dr. Morgan reviewed activities since the March 27, 2008 meeting. Each member was to initiate discussions with other members and other interested parties on the top three alternatives (1, 5, and 8). The goal was to ascertain if one Class 4b whey pricing alternative could receive Committee consensus for a recommendation to the Secretary. Committee members had submitted additional data requests to the Department since March 27th and received further data analyses from the Department.

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A Committee member presented information entitled "Inversion Issue and Solution" which highlighted that the values for whey products moved away from their traditional price relationship during 2007. As result of this presentation, the Committee modified alternative #8 by eliminating the snubbers, requesting that there either be "no cap and no floor" or that there will be "a cap and floor," as well as basing the make allowance upon the cost of the smallest four (4) NFDM powder plants. Members acknowledged that there was no impact analysis available to determine how these changes would have impacted the formula.

Voting

(Alternatives 1, 5, 8, o r "no change")

Each member present (13 of the 14 members) voted for one of the four alternatives for recommendation to the Secretary: 1 or 5 or 8 (modified) or "no change."

The results were:

Alternative #1	0 votes
Alternative #5	0 votes
Alternative #8	5 votes
"No change"	8 votes
	13 votes tallied

A second vote was taken with each Committee member voting either "yes" or "no" on each alternative (1, 5, 8, or "no change"):

Alternative	"YES"	"NO"
Alternative #1	2 votes	11 votes
Alternative #5	4 votes	9 votes
Alternative #8	6 votes	7 votes
"No change"	9 votes	4 votes

The summary statement of Alternative #4 was also amended slightly:

"To create the opportunity for competition for producer milk between the current regulated system and a new regulated and/or unregulated system."


The Committee voted to also recommend alternative #4 to the Secretary. The vote was 10 Yes and 3 No.

Summary

Thus, the two recommendations from the Whey Review Committee to Secretary Kawamura are:

- 1) continue in the near term with the current fixed whey factor of 25 cents per cwt. in the Class 4b formula and;
- 2) explore for the future, in conjunction with the California Legislature, modifications to the milk pricing system such as those presented in Alternative #4.

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