Alliance of Western Milk Producers

Representing California's dairy cooperatives and their producer-owners since 1991

1225 H Street, Suite 102 • Sacramento, California 95814 • 916-447-9941

June 12, 2006

Mr. Dave Ikari
Dairy Marketing Branch
California Department of Food & Agriculture
1220 N Street
Sacramento, CA 95814

Subject: Post Hearing Brief, June 1, 2, 2006, Class 2, 3, 4a, 4b Hearing

Dear Mr. Ikari:

As with the February 2005 Class 4a and 4b hearing, three issues were the major points of disagreement as far as the Class 4b formula was concerned – the cheese yield factor, the whey make allowance and snubber, and the support program commodity purchase prices as floors for commodity values in the Class 2, 3, 4a and 4b formulas. How best to establish the Class 4a and 4b location adjusters will also be touched upon in this post hearing brief submitted by the Alliance of Western Milk Producers.

One issue that there appeared to be disagreement on – updating energy costs in the formulas – can best be addressed with the Alliance's the Alliance's monthly energy adjusting indexing proposal.

Time for the energy cost index

The Alliance's direct testimony and the chart it handed out as part of its testimony shows exactly why the Department must adopt the natural gas adjuster proposed by the Alliance. Having an adjuster for natural gas and electricity would further complicate the formula and probably be somewhat redundant. Most of the electricity produced in Southern California and the South Valley is generated by natural gas. In the rest of California, most of the electricity is produced using water power.

The Alliance proposal is simple. Update the natural gas cost from the manufacturing cost studies by a factor determined using the California State Natural Gas Industrial Price as published by the U.S. Energy Information Administration. The California natural gas price for the month available the 25th of the current milk pricing month would be divided by the California natural gas price for the corresponding month during the cost study year. So, the May 2006 Class 4b make allowance would be increased by a factor arrived at by dividing the March 2006 California State Natural Gas Industrial Price ($10.47 per therm) by the March 2004 California State Natural Gas Industrial Price ($7.70 per therm), 35.97%, times the 2004 cost study natural values for cheese, butter, nonfat powder and whey. As stated previously the adjustment would be made monthly.

Some producers have objected to updating costs on a piecemeal basis. One of the major changes in costs results from energy. An energy index resolves the issue by updating natural gas costs on a regular basis.

Even the Institute calls it an interesting solution. Unfortunately, the Institute also says that CDFA should study it. The Alliance can't emphasize enough how unnecessary a study period is. The Alliance proposal is straight forward and deserves to become part of the pricing formulas without study. It will work and the Alliance urges the Department to make the natural gas adjuster part of the pricing formulas.

Cheese yield

The basic question for the Department remains the same in this hearing as it did in the February 2005 hearing: should the Class 4b milk price reflect the value of milk going into cheese plants, or the value of what the Dairy Institute and those supporting their proposal call "typical" California milk.

The Institute continues to argue that cheese manufacturers already are paying premiums to producers that encourage them to produce higher protein milk for their plants. The Institute says that having a yield factor above "typical" milk (10.00) penalizes them.

The fact is that they are also fortifying their vats to gain the full benefit from higher protein milk. The cost of fortification is part of the non-labor processing cost in the cost studies. In addition, the Department must remember that the premiums paid are voluntary and have been reduced to compensate cheese plants for increased costs in other areas. In fact, the Hilmar witness admitted that Hilmar had greatly reduced its premiums because of increased costs.

The Alliance believes that data presented at the February 2005 hearing, in post hearing briefs and in testimony during this hearing more than support the Department continuing to use a 10.2 yield in the Class 4b formula.

Whey make allowance and whey factor

As during the February 2005 Class 4b hearing, the Alliance and other witnesses presented significant data to show that costs of processing whey in California dry whey plants far exceed what any reasonable person would consider the industry norm. Dr. Charles Ling presented data at the January 2006 federal order hearing on make allowances from a much larger sampling than the three plants CDFA surveyed which resulted in a cost of less than half of the CDFA survey.

At that same hearing an expert witness from West Farms Foods, with plants in Washington, Oregon and Idaho, stated that their cost of drying whey runs 2.71 cents above their cost of producing nonfat dry milk. Sue Taylor of Leprino Foods also testified at that same hearing in support of the West Farms Foods analysis of the increased cost of processing whey versus skim milk. Both of those witnesses had the same interest in testifying at that hearing, to get an increase in the manufacturing cost factor for whey.

Based on that testimony and Dr. Ling's data, the Alliance believes that whey drying costs in California are not representative of the industry and should not be used. Adopting either the Institute's or Land O'Lakes' proposed dry whey make allowance not only encourages existing plants to remain inefficient, but provides a windfall for all whey processors in California.

The Alliance's proposed make allowance should be adopted by the Department with the other solids value snubbed at zero should the value of dry whey fall below the make allowance. As stated in our testimony, the vast majority of whey proteins are going into whey protein concentrate products and not dry whey, and taking the other solids value negative only further enhances the profits of WPC producers.

Once again the Dairy Institute and its supporters have indicated that the Department should drop the whey factor from the formula entirely. The Institute just takes a different approach to achieving that objective: raise the dry whey make allowance to $0.2742 and then drop the dry whey factor from the formula when the dry whey price falls below that make allowance. It would appear that now the Institute agrees with the snubber concept supported by producers, that whey should not have a negative impact on the 4b price. However, they stop short by saying once it goes away it should stay away.

As in the 2005 hearing, besides the Institute's call to get rid of the whey factor, there were several approaches to determining a whey value on the 4b formula. However, the Alliance urges CDFA panel not to do what it did in its 2005 recommendations – say that there was no agreement on what to do by the industry and, therefore, recommend that the whey factor be dropped.

Clearly processing whey provides a positive revenue stream for the vast majority of large scale cheese plants, not as dry whey, but as whey protein concentrate (WPC). Therefore, the Alliance believes that CDFA, at a minimum, should maintain the dry whey factor in the 4b formula adjusting the make allowance as recommended by the Alliance. It should also immediately launch a study on WPC production and sales in California cheese plants. What is the whey product most commonly produced and what does it cost to produce it? With this type of data, the industry and the Department can evaluate what other solids value should be part of the formula.

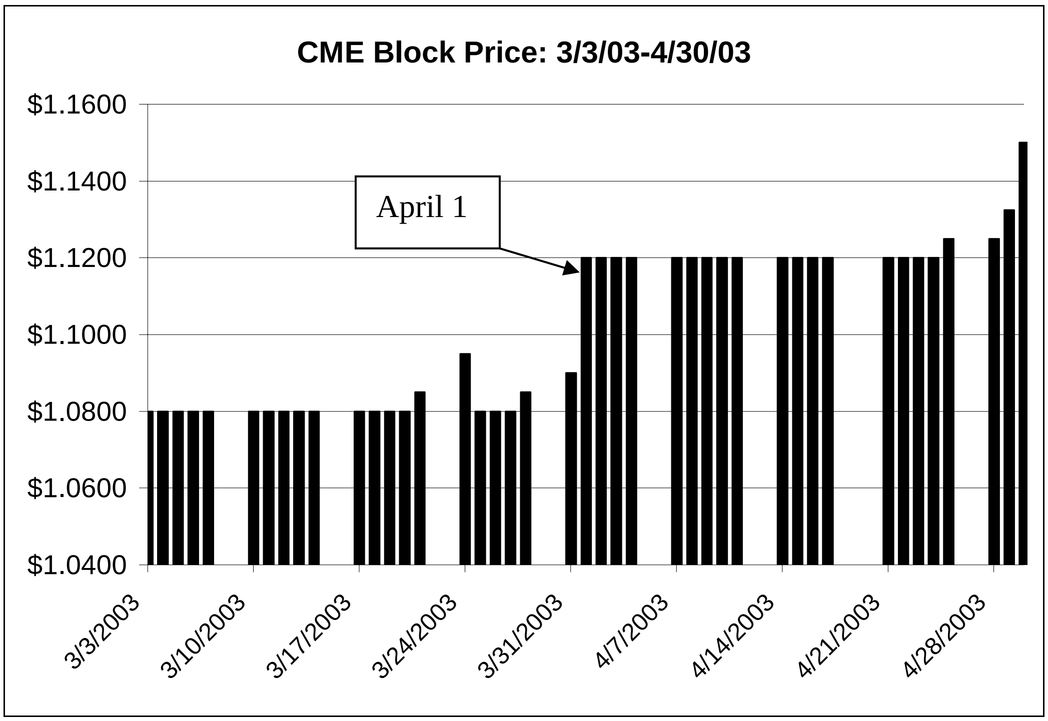
In addition, the Alliance believes that any and all costs associated with whey processing should be removed from the cheese manufacturing cost study data and from consideration by the Department in adjusting the cheese manufacturing allowance. In producing dry whey, <u>all</u> of the components of the skim whey stream are accounted for. It is only in the production of whey protein concentrate that there may be liquids and other components of skim whey left that must be "disposed of." The cost of disposing of them should not be included in the non-labor processing costs in the cheese cost study.

Support program commodity purchase price floor

The Alliance and its members strongly support re-instituting the support program commodity purchase prices as the floor for commodity values in the Class 4a and Class 4b formulas. The Department should keep in mind that cooperatives the Alliance represents would be more directly impacted by this than those opposed to it.

In the past, the price of cheese has fallen far below the support purchase price level without any cheese being sold to the CCC. The Alliance agrees that it costs more to sell commodities to CCC and it supports the efforts of the National Milk Producers Federation to get the Commodity Credit Corporation (CCC) to raise the purchase prices to cover those additional costs. However, the Alliance would also point out that even with the CCC purchase prices as the floor commodity prices, the Class 4b milk price is still nearly 40 cents below the support price. That is because of the location adjuster in the 4b formula. The support purchase price is an FOB plant price, the seller is not responsible to getting the product to the CCC warehouse and, therefore, is not competing with manufacturers back east for a market.

Because California is such a major factor in the cheese market, there is really no disadvantage to California cheese makers by doing flooring the commodity prices in the 4b formula. In 2003, when California adopted the CCC commodity price floor, the Chicago Mercantile Exchange immediately reacted as the chart below shows.



How to establish the cheese location adjuster

The Alliance agrees with the approach recommended by the witnesses for California Dairies Inc. as regards how to establish the location adjusters for cheese and butter. That is, CDFA should require California cheddar cheese and butter manufacturers to file with the Department a copy of the weekly reports that they provide to NASS. This will result in better data for the Department to use in determining the appropriate cheese and butter location adjusters. The location adjusters should be based on a compilation of those weekly weighted averages for 12 months, not 24 months as the Institute proposes. It appear evident that hearings to adjust manufacturing allows will occur on a regular basis and there is no need to use anything other than the most recent 12 months. Of course, if the Department did get the NASS reports weekly from California cheese and butter manufacturers, it could update the location adjusters monthly.

Summary

There is no denying that the cost of manufacturing dairy products in California has gone up between the cost study for 2003 to the cost study for 2004. However, the Department also needs to recognize that the cost of producing milk has gone up as well. One of the challenges the Department faces is balancing the increased cost of manufacturing dairy products with the increased cost of producing milk. As the Alliance stated in its testimony at the hearing, the Department should not use pricing formulas to send signals to producers when to produce or when not to produce milk. The marketplace does that through the commodity values that go into the pricing formulas.

In the same respect, the Department should only make adjustments to milk pricing formulas when the increased cost of doing business justifies making those adjustments. The Department should not make adjustments to formulas for the purpose of sending ***signals*** to manufacturers as to the types of products they should be manufacturing; for example, cheese versus butter and powder.

The Department needs to recognize how milk is marketed in California in making its decision. The vast majority of milk produced in California is marketed through cooperatives. It is cooperatives who gather the milk, test it and sell it to other manufacturers for further processing. It is also cooperatives that balance the market's need for milk with the supply of milk available.

Most of the cheese manufacturers in California get some of their milk from cooperatives. For some, cooperatives are the full suppliers of the milk they process. For others, the cooperatives provide some of the milk, depending on the demand for the cheese manufacturers' products.

One only needs to look at 2006 milk production in relationship to the production of butter, powder and cheese in the June 2006 Dairy Information Bulletin which contains data through April of this year. Milk production is up 5.5% January through April 2006 compared to the same four months in 2005. Total cheese production is up 2.2%, approximately 15 million pounds. Using the yield factor of 10.2 pounds of cheese per 100 pounds of milk, 153 million pounds of the additional 678.6 million pounds of milk produced in California in 2006 went into cheese. The lion's share of the rest of that additional milk production went into butter and milk powders.

When a witness from California Dairies answered a question regarding plant capacity, it seemed that the witness was saying that there was not enough total plant capacity in California earlier this year to process the milk produced. That same witness later again took the stand to clarify what he meant – that there was not enough butter/powder stand-by capacity to handle the additional milk produced, but not wanted by cheese manufacturers.

Again, the proof is in the June 2006 Dairy Information Bulletin on page 17; 14.5 million fewer pounds of cheddar cheese and 8.6 million fewer pounds of Other cheese were produced in 2006 compared to the first four months of 2005. If it hadn't been for Mozzarella cheese increasing production 34.8 million pounds, total cheese produced in California through April 2006 would have been a negative number. The Department should keep in mind that unlike cheddar and other cheeses, Mozzarella can be frozen and stored which explains, in part, why its production is up in 2006.

Page 16 of the June 2006 DIB tells the rest of the story: 35.2 million more pounds of butter were produced and 63.3 million more pounds of nonfat powder were produced the first four months of

2006. Clearly, the burden of balancing California's milk supply falls on the shoulders of manufacturing cooperatives and on the wallets of the producers that own them.

The Alliance urges the Department to keep this in mind as it deliberates what adjustments to make in the Class 4a and Class 4b formulas.

The Alliance believes a strong case has been made to keep the current cheese yield factor by producer representatives. Testimony shows that what cheese processors pay for milk depends on their profitability and not what cheese yields.

Producer representatives have made the case for a reasonable level for the dry whey make allowance. The data is overwhelming that the cost study data is not representative of the real cost of dry whey processing in other states as well as in Washington State.

Taking dry whey out of the 4b formula would dramatically impact producer income in the long-term. Yes, the Department's analysis of the Institute's proposal over the past five years shows that producers would be better off without a whey factor. This is because the analysis covers the previous five years and includes a 27.42¢ make allowance which makes the impact of dry whey negative in 51 of 60 consecutive months. Snubbing the whey value at the Institute's make allowance increases the average 4b price 2001-2005 from $11.82 to $12.13.

The other issue that the Department must consider carefully is dropping the whey factor from the 4b formula. This will reduce producer prices significantly and further skew cheese milk costs toward lowfat cheeses like mozzarella. Over the past five years, without snubbing the whey value, the cost of 4b nonfat solids in the current formula has been $0.8181 per pound, $12.46 per hundredweight of milk. The current formula with the whey snubber would be result in a 4b nonfat solids value of $0.8264 and a 4b hundredweight price of $12.53. If there had been no whey value in the current formula, the average 4b nonfat solids price would have been $0.8010 per pound over the last five years, 1.71¢ per pound less than the current formula.

The support purchase price floor for commodity values in the 4a and 4b formulas should be reinstated. It was effective in keeping prices at a reasonable level without creating a hardship for California processors. The Department must remember that the so-called location adjuster (the difference between what California processors are selling their cheese for and the CME

Finally, it appears the whole basis for the Dairy Institute's justification for their proposal is that no new cheese factories are being planned for California and eight cheese plants have closed. It implies that all of this is because of the California Class 4b milk pricing formula not providing an adequate return on investment. The Department should look at the Institute's Exhibit A attached to their testimony very closely. Of the six plants closed since 1998 (most before the changes made in the Class 4b formula in 2003):

- Azteca Cheese – listeria in cheese
- Sorrento Cheese - high labor costs, lack of nearby dairy farms to supply milk and a lack of affordable land to expand. (From San Jose Mercury News 11/6/2002)
- Suprema Specialties - closed as a result of fraud by owners
- DFA Petaluma - couldn't efficiently compete with other higher-volume cheese plants

- Valley Gold – Old, out-dated plant, sold to Valley Gold by Land O'Lakes when LOL built CPI plant in Tulare, sold to Land O'Lakes by Beatrice in 2000 "the sale was part of an initiative to focus on cream cheese and specialty cheeses."

Regarding the plants considering California, but building elsewhere:

- Tillamook Cooperative – "The Boardman site was chosen because it had the wastewater capacity, water, power and work force needed, and, more importantly, it was a farm-friendly area." Jim McMullen, Tillamook CEO. Plant finished in 2001.
- Glanbia - Three primary factors, Glanbia Foods Executive Vice President Jeff Williams explained in Albuquerque, drove the site selection decision: incentives, site access to a ***very*** large milk supply and the permitting process.
- Blue Ribbon Cheese Company – has been talking about building a cheese plant in California for many years. Lack of investors, not manufacturing costs, a key.
- Gossner Foods - Dolores Gossner Wheeler says the company chose Heyburn, Idaho, because the area offers a city-run anaerobic wastewater disposal system, an abundant local milk supply, natural fresh water wells and many people looking for work. And in California, Imperial Valley Cheese has increased its Muenster production. (Retail Watch, May 12, 2006)
- Hilmar Cheese - The state of Texas offered Hilmar a $7.5 million incentive package from the Texas Enterprise Fund (TEF) to woo the company away from Idaho plus Additional funding for transportation improvements and workforce training, according to a press release from the governor's office. (The Dalhart Texan, December 1, 2005)

Clearly, the cost of manufacturing cheese in California compared to other states was not the main factor in plants closing or cheese facilities being built elsewhere. The availability of an abundant supply of milk had a lot to do with the decisions of Hilmar, Gossner Foods and Glanbia. Incentives offered by state governments also played a major role.

This is not the 1980s when California milk was being shipped back east looking for a home and producers would be better off financially by funding plant construction. The business climate in California has changed as has the availability of a supply of milk. Still, cheese plants have been expanding as the increase in California's cheese production clearly shows. The real crunch is in facilities available to take up excess supplies of milk when cheese plants don't want that milk. And, believe me when I say, based on 30 years of experience in the cheese and dairy business, a milk supply cannot be balanced with cheese plants.

The Alliance urges CDFA to reject the Institute's proposal and instead adopt reasonable make allowance adjustments for cheese, dry whey, butter and nonfat dry milk powder with natural gas costs adjusted monthly based on the Alliance's proposed adjuster.

Respectfully submitted,

Jim Tillison

James E. Tillison, CEO