PUBLIC HEARING

STATE OF CALIFORNIA

DEPARTMENT OF FOOD AND AGRICULTURE

DAIRY MARKETING BRANCH

DEPARTMENT OF FOOD AND AGRICULTURE

1220 N STREET

AUDITORIUM

SACRAMENTO, CALIFORNIA

TUESDAY, AUGUST 28, 2007

9:00 A.M.

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APPEARANCES

HEARING OFFICER

Mr. Mike Cleary

PANEL MEMBERS

Mr. Mike Francesconi, Supervising Auditor I

Ms. Candace Gates, Research Manager I

Mr. Tom Gossard, Agriculture Economist

Mr. David Ikari, Chief, Dairy Marketing Branch

STAFF

Mr. Hiram Doegey, Senior Agricultural Economist, Dairy Marketing Branch

ALSO PRESENT

Mr. John Kaczor, Milk Producers Council

Mr. Jim Gruebele, Land O'Lakes

Mr. Joe Heffington, California Dairies, Inc.

Ms. Tiffany LaMendola, Western United Dairymen

Mr. Scott Magneson, California Dairy Campaign

Mr. William Schiek, Dairy Institute of California

Ms. Patricia Stroup, Nestlé USA, Dreyer's Grand Ice Cream

Mr. William C. Van Dam, Alliance of Western Milk Producers

Mr. Geoffrey Vanden Heuvel, Milk Producers Council

Mr. Tom Wegner, Land O'Lakes

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PROCEEDINGS

HEARING OFFICER CLEARY: Good morning, everybody. If I can get your attention a few little housekeeping things for the sake of making sure this thing runs as smoothly as possible, which is doubtful considering you have me as a hearing officer today.

You're allowed to laugh if I make a comment like that.

(Laughter)

HEARING OFFICER CLEARY: There you go. Okay.

Number one, if you could be kind enough to set all these things to stun so you don't have them ringing in the course of the hearing.

The other thing, the way we're going to run the deal today is if you're going to come up and testify, as I know a number of you will be, the place you will testify is where this young gentleman in the black suit is sitting right here. So just procedurally when it comes time to testify, that's where you'll go.

If you have something you'd like considered as an exhibit, please bring it up first before you sit down to speak. That way we avoid the awkward getting up and having to walk back and forth.

You probably all know where the rest rooms are outside out here. If we run into lunch, we'll probably break for lunch at about 12:30 or so depending on the flow of the testimony. And other than that, as long as we all try to keep this as collegial as possible, I think we should get through the day in one piece and all survive to come back again the next time.

So with that, are there any general questions about what I've talked about so far? Okay. Then we'll begin.

Good morning. This hearing will now come to order. The California Department of Food and Agriculture has called this public hearing at the Department's Auditorium at 1220 N Street, Sacramento, California on this day, Tuesday, August 28th, 2007, beginning at 9:00.

My name is Mike Cleary. I've been designated as a hearing officer for today's proceedings. And I have no departmental interest in this particular matter whatsoever. So pretty independent as far as the issues concerned today.

On June 15th, 2007, the Department received a petition from the Western United Dairymen requesting a public hearing to consider revisions to the weekly and monthly nonfat dry milk sales reports.

On June 18th, 2007, the Department received a petition from Milk Producers Council requesting a public hearing to consider amendments to stabilization and marketing plans for market milk for the northern and southern California marketing areas.

This hearing will consider proposed changes to the weekly and monthly nonfat dry milk sales reports and propose changes to the specific components of the commodities' reference price of the Class I milk pricing formula and the method used to determine the market value of nonfat dry milk used in Class 4a formulas.

This hearing will also consider the factual basis evidence and the legal authority upon which to make any and/or all of the proposed amendments to the plans.

The Department also received two alternative proposals from Dairy Institute of California and Alliance of Western Milk Producers. The petitioners, the Western United Dairymen and Milk Producers Council, will each have 45 minutes to submit testimony and relative material to support their petition, which will then be followed by any questions from the Panel.

Dairy Institute and Alliance of Western Milk Producers having submitted alternative proposals will each be provided 30 minutes to give testimony and evidence followed by any questions from the panel.

Anyone else wishing to testify must sign in on the hearing witness roster located in the back of the room and will be allowed 20 minutes to give testimony and evidence.

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

As a courtesy to the Panel, the Department staff, and public, please speak directly to the issues presented by the petitions and avoid personalizing disagreements. Such conduct does not assist the Panel in any way whatsoever.

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

The panel is composed of members of the Department's Dairy Marking Branch and include David Ikari, Chief of the Branch; Candace Gates, Research Manager II; Thomas Gossard, Senior Agricultural Economist; and Mike Fransenconi, Supervising Auditor.

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

The hearing recorder is of the firm Peters Shorthand Reporting Corporation located in Sacramento, and a transcript of today's hearing will be available for review at the Marketing Branch headquarters located in Sacramento at 560 J Street, Suite 150.

Testimony and evidence pertinent to the call of the hearing will now be received at this time. Mike Francesconi, Supervising Auditor with the Dairy Marketing Branch will introduce the Department's exhibits. The audience may ask questions of Mr. Francesconi only as it relates to the exhibits.

MR. DOEGEY: Actually, it's Hiram Doegey.

HEARING OFFICER CLEARY: Hiram Doegey will present the evidence, because the program decided to swap bodies on us this morning. So forgive me for that. Otherwise, I thought I read fairly well.

SENIOR AGRICULTURAL ECONOMIST DOEGEY: And do I need to be sworn in first?

HEARING OFFICER CLEARY: Yes, you do.

Do you swear or affirm to tell the truth and nothing but the truth?

SENIOR AGRICULTURAL ECONOMIST DOEGEY: I do.

HEARING OFFICER CLEARY: Very well. You may proceed with your testimony.

SENIOR AGRICULTURAL ECONOMIST DOEGEY: Okay, Mr.

Hearing Officer. My name is Hiram Doegey. And the last name is spelled D-o-e-g-e-y. I'm a Senior Agricultural Economist with the Dairy Marketing Branch of the California Department of Food and Agriculture.

My purpose here this morning is to introduce the Department's composite hearing, exhibits numbered 1 through 43. And relative to these exhibits, previous issues of Exhibits A through 43 are hereby entered by reference.

I'm also going to enter into evidence two exhibits. They're actually two letters that were submitted by National Milk Producers Federation. So I'll go ahead and give you those right now.

HEARING OFFICER CLEARY: Sure.

For the stake of the record, we'll enter in the Items 1 through 43, the Department's exhibits. In addition, two additional letters received by the Department. The Department's exhibits 1 through 43, the letters, will be exhibits 44 and 45 respectively.

(Thereupon the above-referenced document was marked by the Hearing Officer as Exhibits 1 through 45 for identification.)

HEARING OFFICER CLEARY: You may proceed.

SENIOR AGRICULTURAL ECONOMIST DOEGEY: The exhibits entered today have been available for review at the offices of the Dairy Marketing Branch since the close of business on August 21st, 2007.

An abridged copy of the exhibits is available for inspection at the back of the room. A copy of the exhibit list is also available at the back of the room.

At this time, I ask that the composite exhibits be received.

Mr. Hearing Officer, the next exhibit that I gave you is letter from National Milk Producers Federation dated July 19th, 2007, and signed by Jerry Kozak, President and CEO.

The exhibit next in order is also a letter from National Milk Producers Federation dated August 3rd, 2007, and signed by Jerry Kozak, President and CEO. Copies of these two letters are available at the back of the room.

Mr. Hearing Officer, I ask for a period of time in which to file a post-hearing brief.

And this concludes my testimony.

HEARING OFFICER CLEARY: Thank you very much. You can sit if you'd like.

MR. KACZOR: Mr. Hearing Officer, point of order. I believe that Department's witness is subject to questions by the audience.

HEARING OFFICER CLEARY: Yes. Are there any questions of the Department's witness?

MR. KACZOR: Yes, I have a few questions.

HEARING OFFICER CLEARY: Certainly. You may address the witness. You can do it from where you're standing. That's fine.

Could you please identify yourself for the record?

MR. KACZOR: My name is John Kaczor. I represent Milk Producers Council.

We haven't looked at the 43 some-odd exhibits. But I think among them would be the question that I have pertaining to some of them.

In the material that the Department presented and was reviewed at the hearing workshop on August 14th, among that material was a draft that was contained or embodied in the discussion of exports of dairy products. And I have a question that -- who prepared the graph?

SENIOR AGRICULTURAL ECONOMIST DOEGEY: That graph was prepared by one of agricultural economists at the department named Dan Peltier.

MR. KACZOR: Of the Department of Food and Agriculture?

SENIOR AGRICULTURAL ECONOMIST DOEGEY: That's correct.

MR. KACZOR: And I notice it was expressed on a per hundredweight basis. And I was wondering that because this hearing is based upon -- centered on skim milk prices and nonfat dry milk prices, why the graph was in hundred weight basis. It seemed strange. Was it just customary procedure?

SENIOR AGRICULTURAL ECONOMIST DOEGEY: Right at the second, I'm not prepared to answer that question. But what I can do is go ahead and research the answer to your question and then provide the answer at the end of the hearing.

MR. KACZOR: Okay. Appreciate that. Some of these questions might have to be answered by the hearing panel. But if not, we'll just go ahead.

One specific question that should be answered is at least in two places in the material presented by the Department and reviewed at the workshop the statement was made that high heat powder is included in the reports that California receives. And yet in the specific instructions for the weekly and monthly reports it says that high heat powder should be excluded. Could someone please clear up that? Is it included or excluded?

SENIOR AGRICULTURAL ECONOMIST DOEGEY: High heat powder would be included in the California nonfat dry milk sales report.

MR. KACZOR: Could you please review the written instructions as to in the paragraph that is what should be excluded?

SENIOR AGRICULTURAL ECONOMIST DOEGEY: Okay. Do you have a copy of the monthly sales report? Is there a specific paragraph that you're referring to that you could point to?

PANEL MEMBER IKARI: I'm wondering if you're thinking about the federal report form versus the State report form.

SENIOR AGRICULTURAL ECONOMIST DOEGEY: It could be.

PANEL MEMBER IKARI: I think you're referring to the federal report form, not the State.

MR. KACZOR: That clears up the answer. Thank you.

In the material again reviewed at the workshop, the Department made a comment that the data was not available to be able to evaluate the Western United proposal and the Dairy Institute proposal. Could you tell us what specific data that is not available that caused you to be unable to evaluate that?

SENIOR AGRICULTURAL ECONOMIST DOEGEY: The sales reports that we received from the various reporting agencies do not always specify exactly the type of powder. For example, if -- actually, you know what? I don't have in front of me the proposals.

HEARING OFFICER CLEARY: Would you like the exhibits back would that help you reference your answer?

SENIOR AGRICULTURAL ECONOMIST DOEGEY: A copy of the proposal, because I've forgotten off the top of my head the exact --

MR. KACZOR: There's one aspect of the comment between the two proposals, Dairy Institute and Western United, and that has a cutoff date beyond which sales of nonfat dry milk product should not be made. Is the fact that the Department does not know those numbers that precluded them to evaluate the proposals?

SENIOR AGRICULTURAL ECONOMIST DOEGEY: Which cutoff date? What do you mean by cutoff date?

MR. KACZOR: Western United proposed a 90-day period, and Dairy Institute proposed a 30-day period.

SENIOR AGRICULTURAL ECONOMIST DOEGEY: Right. That is correct. When it comes to any, say, long-term contract sales, the sales reports that the Department receives in does not specify specifically the time frame or the length of any such long-term contract, nor does it specifically state whether or not a sale is a contracted sale or a spot sale index sale. That information just isn't made available to us currently on the sales reports that we receive.

MR. KACZOR: Okay. Thank you. Last question has to do with the audits. Again, having to do with material that was discussed and reviewed at the workshop, the Department started out by saying the weekly and monthly reports submitted by California manufacturing plants are audited. And we discussed it briefly at the workshop, but I wonder for the record of this hearing, could I have a few questions regarding the audit procedure? Would you be prepared to be able to describe that procedure?

SENIOR AGRICULTURAL ECONOMIST DOEGEY: Well, what might be helpful is if you were to tell me what the questions were. And then if I don't know them at this second, we can also research that and then provide that answer at the end.

MR. KACZOR: First as a general matter, the reports come first in on a weekly basis, a seven-day basis. And what auditing procedure is applied to those figures?

SENIOR AGRICULTURAL ECONOMIST DOEGEY: So I'll go ahead and research the answer to that question and get back.

MR. KACZOR: Thank you. A follow-up question is are any of the -- and this would apply to the monthly reports. Are any written reports made of the audits?

SENIOR AGRICULTURAL ECONOMIST DOEGEY: In terms of is there a written record of the audit, you mean?

MR. KACZOR: Yes.

PANEL MEMBER GOSSARD: Mr. Kaczor, I have a clarifying thing about what do you mean by a written report, a formal letter signed by someone saying --

MR. KACZOR: Any documentation that was prepared in the course of making the audit that would have been kept in the Department's files, any form: Notes, comments, formal report?

SENIOR AGRICULTURAL ECONOMIST DOEGEY: Okay.

MR. KACZOR: Another question is because we understand that a significant portion of those reports is reported by a single entity, a sales agency, representing a number of plants. When that report is audited, are the individual plants contacted, or does the sales agency answer the questions?

SENIOR AGRICULTURAL ECONOMIST DOEGEY: Okay. So the question then is if there is -- if department were to have any questions regarding the sales report, do we go to the individual companies that belong to the organization or do we go straight to the organization for.

MR. KACZOR: Exactly. Yes. In the same line with respect to the weekly and perhaps more specifically to the monthly reports, does the auditing procedure take a look at sales made by the plants to other plants or transfers made by the plants to other plants or transfers in or purchases from other plants?

PANEL MEMBER IKARI: Mr. Kaczor, what do you mean by take a look at?

MR. KACZOR: Do they ask questions regarding those matters and do they record the figures and answers?

PANEL MEMBER IKARI: Do they ask and record the figures? You mean included or excluded in the report?

SENIOR AGRICULTURAL ECONOMIST DOEGEY: Taking a look at the entire plant, there is a number of transactions that occur during the week and the month that include receiving milk, producing product, selling product from inventory, selling current produced product. There's also sales between plants occasionally. There are transfers between plants. There are purchases from plants and transfers in from plants. And they all come into the mix of products that may be included in the sales reported by the plant or those agencies during that period.

PANEL MEMBER IKARI: I'm just trying -- if you ask a specific question, we can get your specific response. But if the question is vague, you're going to get a vague answer.

MR. KACZOR: Well, I specifically mean --

PANEL MEMBER IKARI: The question was when you said take a look at the inter-company sales, yes, the Department does take a look at. But I think you want more than that. And if you could be more specific, I think it would be helpful for us responding to that question.

MR. KACZOR: With respect to the auditing procedure -- and I'm not quite clear on what the auditing procedure involves -- I'm wondering if, if a plant makes a sale to another plant with respect to within the same organization or to another plant inside California or outside California, is that noted? And is it evaluated with respect to the sales reported by that plant?

Similarly, transfers in or purchases from following the same category, they all take into consideration or affect the product that's available by the plant, plus beginning inventories and ending inventories. That would seemingly be part of an audit. And we're asking is that done? Or do you simply take a look at the sales reported and verify that the plant in fact did make those sales, regardless of the origin of the sales?

SENIOR AGRICULTURAL ECONOMIST DOEGEY: So maybe I can restate that question.

So specifically you're interested in knowing whether or not the Department during the auditing procedure verifies the company from which the sale might originate and to what company the powder might be going to specifically to determine whether or not that would be an inter-company sale or transfer.

MR. KACZOR: Or coming from.

And lastly with respect to a true audit of any plant, based upon my knowledge of the studies that the Department made of processing plants back when they were setting minimum resale prices, the audit started with a general ledger. And do any of these audits, perhaps more appropriately to a monthly report, involve starting with a general ledger and following through the sales transactions and the credits and charges and so forth?

SENIOR AGRICULTURAL ECONOMIST DOEGEY: Okay.

MR. KACZOR: And that completes my questions. Thank you.

HEARING OFFICER CLEARY: Thank you, Mr. Kaczor.

Do we have any other members of the public that would like to ask questions of the Department's witness? Thank you very much.

At this time, I'd like to call Western United Dairymen up. You'll have 45 minutes to submit your testimony. You'll notice that we have a time clock running over here to my right.

And good morning. How are you today?

MS. LA MENDOLA: Good. How are you?

HEARING OFFICER CLEARY: Good.

Could you please state your name and affiliation?

MS. LA MENDOLA: Tiffany LaMendola, L-a M-e-n-d-o-l-a, Western United Dairymen.

HEARING OFFICER CLEARY: And do you swear or affirm to tell the truth and nothing but the truth today?

MS. LA MENDOLA: I do.

HEARING OFFICER CLEARY: Was it your intention to have your written testimony entered into the record today?

MS. LA MENDOLA: Yes, please.

HEARING OFFICER CLEARY: The written testimony from Western United Dairymen will be marked Exhibit 46.

(Thereupon the above-referenced document was marked by the Hearing Officer as Exhibit 46 for identification.)

HEARING OFFICER CLEARY: You can proceed.

MS. LA MENDOLA: Mr. Hearing Officer and members of the Hearing Panel, my name is Tiffany LaMendola. I'm the Director of Economic Analysis for Western United Dairymen.

Our association is the largest dairy producer trade association in California representing approximately 1,100 of California's 1800 dairy families. We are a grassroots organization headquartered in Modesto, California. An elected Board of Directors governs our policy.

Our Dairy Programs Committee met June 8, 2007.

And our Board of Directors met June 15, July 20th, and August 17th, 2007, to approve the position we will present here today.

A call for change. According to CDFA data, the nonfat pricing series is reported by NASS and the California weighted average price using California has historically tracked well, despite differences in reporting procedures. The historic relationship was, however, disrupted starting in late 2006. Subsequent issues with the reporting of nonfat dry milk prices by NASS and resulting revisions by NASS brought further attention to the large and uncommon differences in the NASS and CWAP pricing series. The inclusion of long-term pricing contracts in the CWAP was singled out as the obvious difference. Industry representatives pointed to a delay in the fulfillment of the fixed price contract as a major factor depressing California nonfat dry milk prices in June of 2007.

Our members asked us to glean a better understanding of the issues involved, as they were very troubled by the dramatically lowered nonfat dry milk price reflected in California.

The Department held two meetings, May 16th and May 31st, to discuss the issue in attempts to foster discussion. The information offered at these meetings was minimal and fell short of the specifics needed to determine the best resolution. While we understood that revisions could be done administratively, our members felt a hearing process was needed in order to have full disclosure of all implications of change. A formal hearing process seemed the best way to get the appropriate facts on the table so that the Department can make the best decision.

Our proposal. The long-term contract, which depressed nonfat dry milk prices in California, was filled in late June. And prices are currently in better alignment. Even though that occurred, our members are interested in proposing changes to the CWAP pricing procedures in order to avoid a similar occurrence in the future.

To that end, our proposal makes changes to the weekly and monthly nonfat dry milk sales reports that are submitted to CDFA. Specifically, we ask that only those contracted sales that are delivered within 90 days of contract execution shall be included in the weekly and monthly CWAP prices. That is, we support the inclusion of sales for which prices are set up to 90 days before the transaction is complete, i.e., nonfat dry milk is shipped out and title transfer occurs.

The required modifications to the weekly and monthly nonfat dry milk sales reports will need to be determined by CDFA staff. We suggested separating out contracted sales on the reporting form as a possible mechanism to identify the volume and prices associated with those sales.

The intent of our proposal. Neither Western United members nor staff is an expert in the manufacturing and marketing of nonfat dry milk. With the information we have been able to gather, we put together a proposal with the intent to capture nonfat dry milk prices that are reflective of current market conditions while at the same time allowing for some flexibility in the marketing of nonfat dry milk and price risk sharing.

We sincerely hope that industry representatives with insight and experience in the marketing of nonfat dry milk are diligent today in providing as much information as possible. Ignoring or discounting the issue will only harm the process of implementing changes that are in the best interest of the industry. Education on this issue is vital.

Current market conditions. Both California and federal milk marketing orders use a system of end product pricing. Cheese, dry whey, butter, nonfat dry milk are the products used to determine the value of raw milk. Because of the inclusion of fixed price contracts, nonfat dry milk is the only commodity for which reported prices used in setting monthly minimum prices can deviate significantly from current market or spot prices.

Minimum class prices, with the exception for Class 2 and 3 which are set bimonthly, are set monthly and reflect current supply and demand conditions for that month. Generally, if supply exceeds demand, prices are lower and vice versa. Producer prices are reflective of the conditions.

However, this wasn't necessarily the case for much of 2007 when producer prices in California were much lower than the rest of the nation due to the inclusion of lower priced forward contracted volume. In fact, to do the lower CWAP prices and subsequently lower class 4a, 2, 3, and potentially Class 1 prices, pool prices paid to producers were an estimated one dollar per hundredweight lower for several months. The usual predictors of price, demand, production, inventories, et cetera, were muted against large volumes of powder that was priced many months prior. Our members feel that outcomes such as this are in conflict with the general intent of end product pricing.

Flexibility in marketing. Opponents will likely argue that our proposed changes will inhibit the ability to market California nonfat dry milk internationally. It is not WUD's intention to impair a manufacturer's ability to compete in the global marketplace. We are well aware of the need to maintain this ever-growing market for California produced products, as it is certainly a market of our future.

However, we also do not understand why marketers of powder would be unable to operate under our proposed price reporting procedures. A review of information at our disposal reflects the following:

Our proposal allows for the inclusion of fixed price volume within a 90-day period. This doesn't mean marketers cannot offer a longer fixed price forward contract. It just means that the risk of price fluctuations beyond 90 days will need to be hedged. The risk of price fluctuations within a 90-day period will be borne by the producers, the risk beyond 90 days will be borne by the manufacturer or marketer of the product.

Understandably, the global marketing of powder is no easy task. Resources are needed to research, plan, and make critical marketing decisions. It is our understanding that DairyAmerica, which markets the vast majority of powder in the United States, has a partnership with Fonterra to handle international marketing of powder. According to the Fonterra website, Fonterra is one of the top six dairy companies in the world by turnover, the world's leading exporter of dairy products, and responsible for more than a third of international dairy trade. We would imagine this partnership could enhance the ability to market U.S. powder worldwide and significantly reduce the hurdles to international trade.

A vast amount of information is available through the U.S. Dairy Export Council. The information is aimed at reducing the time needed to research and identify strategies to capture and maintain international markets.

Sharing risk. Of concerns to our members is the fact that with current reporting procedures, all risk associated with fixed price forward contracts is borne by the producers. As we understand, most contracts are volume driven. That is, a certain volume of product is contracted at a certain fixed price, and the length of time needed to deliver the contracted volume is not necessarily pre-determined.

The negotiated fixed price and associated volume are reflected in the CWAP price for the period in which it is delivered, regardless of its relation to the spot price for that period or contract execution date. The CWAP nonfat dry milk prices are then used to set minimum class prices for the same period. This means a forward contracted price negotiated on June 1st, 2007, for instance, could be reflected in the minimum Class 4a price for January 2008 or any other month depending on when the volume is shipped.

Producers generally have no control over forward contract specifications or time frames involved, but do assume the risk during occasions when lower price contracts are factored in with higher priced spot loads in the monthly CWAP prices.

Our proposal with a 90-day window would help spread risk between producers and processors. That is, producers bearing the risk of price movements within a 90-day period and processors assume the risk for any contracted product shipped beyond 90 days.

Some simple examples illustrate our point, which I included here.

Under our proposal illustrated in the examples above, both parties assume a portion of the risk associated with any significant price movements, up or down.

In a time of declining market prices, producers assume the risk of losing potentially higher priced contracted sales shipped beyond 90 days from the reported CWAP and subsequently lower Class 4a prices. In the example above, the ten million pounds shipped beyond 90 days is not included in the monthly CWAP price. This results in an estimated Class 4a price that is $.87 per hundredweight below the Class 4a price if that contract volume had been factored. Processors reap the benefit of higher prices on the contracted volume and lower Class 4a prices.

Alternatively, during periods with quick price increases producers are protected from the risk of lower priced contracted volume shipped beyond 90 days from depressing prices and are privy to higher Class 4a prices reflective of current market conditions. In the example above, the Class 4a price is $.87 per hundredweight higher due to the exclusion of the last ten million pounds of contracted volume. The risk for any products shipped beyond 90 days is shipped to the processors.

Because the marketer or processor of nonfat dry milk is privy to the exact volumes and prices for contracted sales that are shipped beyond 90 days from contact execution, they have the ability to utilize risk management tools. Through the Chicago Mercantile Exchange, nonfat dry milk features have historically experienced little to no volume, the tool is available. I have been told that the Exchange has historically lacked interest from sellers of nonfat dry milk but that buyers would be eager to participate.

As posted on the CME website, CME nonfat dry milk futures contracts broaden the scope for dairy industry trading as a product readily trades worldwide. CME nonfat dry milk features complement the exchange overall dairy product complex. The importance of having futures and options on milk and the major milk products sets the stage for complete risk management in the dairy industry. Trading milk against its product or the products against milk is practically as natural as milk itself.

Though we recognize some initial resistance and potential barriers to trading nonfat dry milk futures at the CME might exist, we believe this market could eventually experience the same liquidity and interest as other dairy contracts at the exchange, especially as buyers worldwide turn to U.S.-sourced powder.

USDA revisions to NASS procedures. We recognize that our suggested changes do not mirror the nonfat dry milk sales report specification set forth in USDA's interim final rule on dairy product mandatory reporting program published in the July 3rd, 2007, federal register. However, AMS has specifically asked for comments on the nonfat dry milk sales report specifications in their interim final rule, stating, "...AMS specifically invites comment on the prevalence of the use of forward contracts and whether they need to be addressed in some way under the mandatory program..." Comments must be submitted by September 4th, 2007.

There is no way to determine when USDA will issue a final rule. A major benefit of California's state pricing and pooling system is the ability to make timely adjustments. As a direct result, California is often recognized as the leader in setting dairy policy.

Given California's tremendous role in the production and marketing of nonfat dry milk, we believe USDA will look to the findings of CDFA for partial guidance in their final decision. We also believe USDA will rely heavily on comments submitted by industry stakeholders. Though we cannot anticipate all comments that will be submitted on the issue, we are aware that National Milk Producers' Federation will be submitting suggestions regarding the inclusion of forward contracted sales that are in line with those suggested by Western United with the exception of a 30-day limitation on domestic sales. National Milk will also stress the need for alignment in pricing procedures and reported prices in California and federal orders.

We are hopeful there will be some convergence of the two reporting systems. If California's procedures stay status quo with no limitations and the USDA adopts its interim ruling, it seems there would be no alternative to sourcing all exports out of California. It is impossible to predict whether this would result in lower or higher prices in California, but almost certainly a large divergence would occur between California and the federal order pricing. Large, sustained discrepancies are a catalyst for disorderly marketing practices and arbitrage incentives would undoubtedly develop.

Milk Producers Council petition. Though the nonfat dry milk price as reported by Dairy Market News may be reflective of current market conditions, we cannot support its use due to the fact that the information is collected via informal telephone surveys and is not audited.

Furthermore, the mostly series is transaction driven and not volume weighted. This means that prices reported may not reflect the sales price for which most of the volume may have moved.

We prefer to maintain the price reporting procedures in California, a process that is completed and verified by CDFA staff and is subject to oversight by industry stakeholders.

Alternative proposals.

Alliance of Western Milk Producers. Western United does not oppose the exclusion of organic milk powders from the weekly and monthly nonfat dry milk sales reporting. It is our understanding that the volume currently represented by organic powders is minor.

Dairy Institute of California. We recognize that the Institute's proposal has some similarities to Western United's in that it seeks to reflect current market conditions by allowing only a 30-day window for inclusion of fixed price contracts. The Institute's proposal is also identical to the specification outlined in USDA's interim final rule.

Changes to specifications of nonfat dry milk reporting beyond the handling of contracted sales were not a focus of our proposal. However, some modifications have been suggested by the Dairy Institute. Discrepancies between CWAP and NASS procedures pertaining to container types, sizes, et cetera, have not and do not seem to foster any large deviations in the resulting prices reported. In fact, NASS and CWAP have historically tracked well within a narrow range. We realize, however, CDFA will be faced with the task of making the final decision and we therefore offer suggestions where possible.

The exclusion of high heat nonfat dry milk. According to information published by the American Dairy Products Institute, nonfat dry milk is classified for end product use according to the heat treatment used in its manufacture. The classifications are: High-heat, medium-heat, and low-heat. According to ADPI, "Higher temperatures and/or extended holding times contribute directly to the whey protein denaturation." The recommendations for the following heat treatments were listed:

Low heat: Fluid milk fortification, cottage cheese, cultured skim milk, starter culture, chocolate dairy drinks, and ice cream.

Medium heat: Prepared mixes, ice cream, confectionary, meat products.

High heat: Bakery, meat products, ice cream, prepared mixes.

While the heat treatment determines the functionality of the nonfat dry milk, it does not seem to change the product definition or composition of the product. Furthermore, the end uses of high heat nonfat dry milk are not of higher value than the uses for low or medium heat products. In fact, some of the same. Finally, we understand that CFDA does not differentiate between low, medium, high heat nonfat dry milk when collecting nonfat dry milk manufacturing costs.

There does seem to be a small deviation in prices reported by Dairy Market News for high-heat nonfat dry milk, which is the only source which segregates low and medium prices from high heat prices.

Since January 2002, high heat prices have exceeded low or medium heat prices by an average of 1.9 cents ranging from a negative 4.5 cents to positive 12.6 cents. In 16 of the last 67 months, high heat prices were lower.

Based on the information above, we see no justification for excluding high heat nonfat dry milk.

Container sizes. Presently, CWAP sales reports include all types of Extra Grade and Grade A nonfat dry milk regardless of container size. NASS specifies 25 kilogram bag, 50 pound bags, tote and tanker sales. We are unaware of any additional container sizes in those specified by NASS. We do not see the need to list the specific allowable container sizes. CDFA should continue to collect all container sizes.

Age of product. Presently, CWAP sales reports include all types of Extra Grade and Grade A nonfat dry milk regardless of the length of storage. NASS excludes sales of nonfat dry milk more than 180 days old. Perhaps there is some chance of older product being perceived as lower quality and sold at discounted prices. However, we see no need to adopt this exclusion in California as we expect that most powder would be marketed within that time frame due to the cost associated with holding inventory.

Intra-company sales. Specific difference between CDFA's procedures and those suggested by USDA are unclear to us. In so much that USDA's suggested process deviates from the specified by CDFA, we object. CDFA's procedures state, "Reported sales shall not include sales or transfers to other plants in the same organization, subsidiary affiliate, partner, fiduciary interest, et cetera."

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

And I'd also like to request that I can reserve the balance of my testimony time for the end of the hearing.

HEARING OFFICER CLEARY: Thank you very much.

Note for the record she has 25 minutes left on the clock and we'll allow you to do that.

At this time, does the Panel have any questions?

PANEL MEMBER GOSSARD: I have one question about your proposal.

You state that you want to exclude those sales regarding contracts that are more than 90 days old. Do you mean both fixed price contracts and index contracts, or do you only mean fixed price contracts?

MS. LA MENDOLA: We're looking for a 90-day period from the time the price -- the contract is executed. I don't think we specified whether that would be a fixed price or an indexed price. So if it was indexed and changed within that 90-day period, it would be included.

PANEL MEMBER GOSSARD: So as long as the price changes within 90 days, it would be included. It's only if the price doesn't change within 90 days --

MS. LA MENDOLA: I think that's more specifically how USDA handles it, and we didn't use that exact wording. But we're looking for narrowing it down to 90 days from when the contract is entered into.

PANEL MEMBER GOSSARD: No further questions.

HEARING OFFICER CLEARY: Anyone else on the Panel have any questions?

PANEL MEMBER IKARI: Yes, I do.

Let me follow up on the question of the 90 days. For clarification purposes, it would be helpful to know your position with respect -- suppose a processor of powder issued a fixed contract for 90 days every day during the 90-day period. So January 1, 90-day contract, fixed price. January 2nd, 90-day contract, slightly different price.

When the Department goes and collects the information, I assume then that as long as the 90 days is there you can see that you're going to have a variation. What's the position of Western United with respect to that if we are faced with that, how do we handle that?

MS. LA MENDOLA: That would be a lot of work to issue contracts that way.

PANEL MEMBER IKARI: But it's possible.

MS. LA MENDOLA: So of those contracts the volume shipped within 90 days would be included.

PANEL MEMBER IKARI: So if there's X amount during the month, then you would just pro rate it?

MS. LA MENDOLA: Yeah. So if each contract would be held individually and the volume shipped on that contract within 90 days would be included, just would be a lot of work to track that if that's how it happens. But I can't imagine that's how contracts are entered into on a daily basis. But I would be wrong.

PANEL MEMBER IKARI: I'm curious how 90 days was arrived at. What justification 90 days, 60 days, 120 days?

MS. LA MENDOLA: You know, we did try to do a lot of fact finding and get our arms around what a good length of time would be just on various anecdotal information. That seemed like a period that a great amount of volume could be shipped, a contract could be executed. It was a compromise. Rather than ratchet it down to 30 days, we tried to leave some room for flexibility.

PANEL MEMBER IKARI: Thank you.

During your testimony you talked about USDA's revisions and NASS procedures. You talk about the Department -- California system is more timely. What's your position if NASS rules suddenly change or are significantly different than the proposed interim rules?

MS. LA MENDOLA: Sure. I don't think California's ever waited to see what USDA comes up with. We know that can take two and three years' length of time. I think we need to do what's best for California, make the changes. And if there is some huge deviation from what USDA comes up with, then we'll have to look at it then. But that could be years down the road.

PANEL MEMBER IKARI: Finally, one question. Is it more important to track with the federal order prices or provide opportunities to sell California products on the world market? What's Western United's position?

MS. LA MENDOLA: I think you have to have a balance. You certainly don't want prices, you know, being completely out of line with federal order, because you're just going to have a huge amount of disorderly marketing practices. Products are going to move from California to State or federal orders when it's conducive and people can make money and vice versa. I don't think that would be in the best interest of anybody. But it's a balance.

PANEL MEMBER IKARI: So let me go further on that. Suppose that we implement Western United's proposal and go with 90 days, and USDA issues a rule that's very strict. Suppose they limit the 60 days, and we have a deviation with the USDA. Would it be Western United's position to come back and ask for a hearing to adjust our procedures?

MS. LA MENDOLA: We don't have policy on that right now, David. I can't say. To guess what USDA is going to do is very difficult. I think we need to take the facts that are given today and make the best decision for California.

PANEL MEMBER IKARI: Thank you.

HEARING OFFICER CLEARY: Panel have any other questions?

PANEL MEMBER GATES: Just one more.

I want to follow up on what Tom had asked you on the 90-day sales. If I understood you correctly, you were saying it doesn't matter if there's a contract that's entered into that maybe was 120 days or longer, but if it was adjusted on some sort of market price or whatever within that time frame, you're talking about just 90 days only; right? There's no adjustment within there, if I heard you correctly.

MS. LA MENDOLA: We're looking at a 90 days so that the volume shipped within 90 days will hopefully reflect market conditions. So if a contract is entered into, has 90 days for that product to ship, that's kind of how we looked at it. Changes between --

PANEL MEMBER GATES: Different than NASS has right now?

MS. LA MENDOLA: Yeah.

PANEL MEMBER GATES: I just want to make sure it was different. That's what I understood you to say.

HEARING OFFICER CLEARY: Any further panel questions of the witness?

If not, you're excused at this time. And we will credit the remaining 25 minutes to the end of the hearing. Thank you.

If I could at this time call up the Milk Producers Counsel, the representative for the Milk Producers Counsel.

HEARING OFFICER CLEARY: Will both of you be presenting today?

MR. KACZOR: Yes, we will.

HEARING OFFICER CLEARY: If I could have individually state your name and spell your last name for the record. And if you could just let us know your affiliation.

MR. VANDEN HEUVEL: My name is Geoffrey Vanden Heuvel. First name, G-e-o-f-f-r-e-y. Last name, V-a-n-d-e-n H-e-u-v-e-l.

MR. KACZOR: My name is John Kaczor. Last name is spelled K-a-c-z-o-r. I'm representing Milk Producers Council.

HEARING OFFICER CLEARY: Thank you, sir.

And was it your intention to have a written copy of your testimony included in the record, sir?

MR. VANDEN HEUVEL: Yes, please.

HEARING OFFICER CLEARY: That document will be marked Exhibit 47 and entered into the record as such.

(Thereupon the above-referenced document was marked as Exhibit 47 for identification.)

HEARING OFFICER CLEARY: Thank you. And you may begin your -- well, I'm sorry. If I could get both of you to answer, do you swear or affirm to tell the truth and nothing but the truth?

MR. VANDEN HEUVEL: Yes.

MR. KACZOR: I do.

MR. VANDEN HEUVEL: Mr. Chairman and members, my name is Geoffrey Vanden Heuvel, and I'm a dairy producer with operations in San Bernardino and Riverside Counties. I am testifying today on behalf of Milk Producers Council, a producer trade association with approximately 100 producer members located primarily in southern and central California.

Also with me today representing MPC is John Kaczor. John has a Bachelor's Degree in marketing from the University of Wisconsin and Master's Degree in Marketing Research from U.C. Berkeley. He began his dairy industry career in 1964 as an economist for a number of processor trade associations in northern California. Over much of that time, he has served as an economist for the Dairy Institute of California. He continued in that capacity until 1978, at which time he joined the private sector, working for two different dairy companies for 22 years in various management, administrative, and liaison capacities until his retirement from full-time work in 2000. Since then, he has remained active in the industry in a consulting capacity.

It is unfortunate that this hearing is taking place. The Department has the full authority to have administratively corrected what has turned out to be a massive debacle for the California dairy industry.

The real issue facing the Secretary today is how is he going to bring California's milk pricing formulas into compliance with the law.

Section 62062 of the Food and Agriculture Code is the statute which specifically instructs the Secretary about the criteria he must evaluate when setting milk prices. Important, it also establishes a comparison point to which any price he establishes must conform. That standard is summarized by this excerpt from Section 62062 quote, "If the director adopts methods or formulas in the plan for designation of prices, the methods or formulas shall be reasonably calculated to result in prices that are in a reasonable and sound economic relationship with a national value of manufactured milk products."

The Legislature has given the Secretary broad latitude in setting milk prices. Later on in Section 62062, many different criteria are listed, which the Secretary must consider when setting prices. But as the plain language of the statute makes clear, at the end of the day, California milk prices shall be in a reasonable and sound economic relationship with the national values.

The reason for this seems obvious. The Secretary is obligated to make sure that the prices he establishes do not disadvantage California producers and processors relative to their competition in the rest of the country. To accomplish that mandated result it is self-evident that the base price for the formulas in the two systems must be very close. The law is there as a check on the Secretary's discretion.

To help understand what reasonable and sound economic relationship means in a competitive dairy industry, we refer to the testimony and evidence that was considered in last year's hearing on make allowances for the 4a and 4b price formulas. There were five proposed changes to the make allowance to the 4a price formula. The total change between the lowest and highest proposals was one and two hundreds of a cent per pound. CDFA's determination was to establish an allowance that was within that range, nine-hundreds of a cent above what the petitioner proposed.

The point here is that the dairy industry is competitive to the extent that fractions of a cent per pound of product are valuable. That fact suggests that reasonable and sound does not apply to what is now happening with respect to the differences in the basis for determining the value of nonfat dry milk in California.

In that hearing, there was extensive discussion and debate over the make allowances. It included discussions on the need to be competitive, on the value of encouraging additional plant investment, on the need to consider producer income. No attention was given to the product price basis to which the make allowance applied because it was not an issue then. Since then, it has become an issue, which is costing California producers many millions of dollars.

The problem was first noticed in late 2006 when the nonfat dry milk sales prices reported to the

Department began to drift below the national price series reported by NASS. The single specific reason for that price spread, which by May 15th had widened to an unbelievable 39 cents per pound, was the inclusion of sales by a major California manufacturing organization at prices that were set under long-term contracts. This was happening over the same period when the international supply and demand situation for nonfat dry milk was swinging from a surplus situation to a deficit position. Unfortunately for California producers, the negative impact of those long-term contracts was multiplied because our research shows that a disproportionate amount of California nonfat dry milk was exported at well below cash market prices under those contracts.

The vast majority of nonfat dry milk in the United States is controlled by one entity, which has powder plants in a number of locations across the U.S. It seems clear that because the California powder reporting rules allows those low, long-term contract prices to be reported and used as the basis for establishing a 4a minimum prices, margins for that entity could be protected by filling those low price contracts from California as opposed to a federally regulated area, where long-term fixed priced contracts are prohibited from being considered as part of the milk price product value formulation.

It became very clear in the spring of 2007 that the nonfat dry milk price being collected by CDFA for usage in a Class 4a formula was not keeping up with the national value of nonfat dry milk. In a moment, my colleague, John Kaczor, will provide for the record an evaluation of exactly how much the difference in the California price compared to the NASS price has cost California producers, and the amount is staggering. He will also report estimates of just how much nonfat dry milk that is exported from the United States appears to have been reported by California plants.

Milk Producers Council and other California producer groups responded to the growing crisis by asking the Department for change. The Department finally held a meeting in Fresno on May 16, 2007, where the issue was discussed.

The Department then added discussion of this issue to the agenda of the regularly scheduled Dairy Advisory Committee meeting on May 31, 2007. Extensive discussion did occur. And by that time, the great disparity between the California price and the national price was obvious.

By the middle of June, there was still no word out of CDFA that any change was being contemplated. And so in desperation, Milk Producers Council petitioned for this hearing. CDFA responded by granting a hearing, but scheduled it for over two months away. Producers are wondering why did the Secretary wait so long to address this issue. We've attached the letters that Milk Producers Council gave to the Department in both May 16 and May 28th.

John Kaczor will now present the data he has developed outlining the magnitude of this debacle.

MR. KACZOR: Mr. Hearing Officer and members of the Hearing Panel, my name is John Kaczor. I'm appearing today on behalf of the Milk Producers Council. This testimony has been reviewed and approved by the senior management of Milk Producers Council.

One of the reasons we have asked to have the weighted annual averages of the weekly and monthly reports of nonfat dry milk sales prices that are published by the National Agricultural Statistics Services, NASS, and by the California Department of Food and Agriculture, CDFA, is to establish in our mind and to demonstrate to others what the base line differences have been between California plants and all plants in the U.S. that manufacture at least one million pounds of nonfat dry milk per year. That figure is the basis for NASS accepting report from nonfat manufacturing plants.

We thank CDFA staff for providing these calculations. We also are thankful for the detailed computations and comparisons of the weekly reports of the mostly prices for nonfat dry milk that are discovered and published by Dairy Market News. Those reports have been used to evaluate and validate our proposal today.

For the record, we note that the document entitled "NFDM Prices, Weighted Annual Averages, 2002 to 2007," shows a consistently close relationship between the CWAP series and the NASS series. The NASS report, since its beginning, has been considered to be the most objective measure of the current national value of nonfat dry milks. In fact, current value is one of the criteria the agricultural marketing service established for using commodity prices as a basis for establishing minimum prices in federal order areas.

I want to emphasize AMS has asked for current values. They've instructed NASS to develop a reporting procedure to develop current values. And that is why they have established the 30-day limitation beyond which a sales should not be reported.

The difference between the two simple averages of the weighted annual averages of the two price series for the years 2002 through 2005 is about seven-tenths of a penny per pound. Again, I digress. That is a computation provided by CDFA staff which we've been asked for and appreciate very much. Two-sevenths of a penny per pound over a 40-year period.

During that period, the annual average NASS prices ranged from more than ten cents above the U.S. support level in 2002, down to a price close to support in 2003, and back up to more than 13-and-a-half cents above support in 2005.

The CWAP series followed a path and a range that was similar to the NASS pattern as evidenced by the weighted average comparison. The close relationship between those two price series continued through the first half of 2006, after which they starting diverging. We believe that relationship between these two major price series over that period of time establishes a base line for measuring normal differences between the two. More importantly, because the substantial price movements for nonfat dry milk during that period reflected substantial changes in the supply and demand for the product during that period, the correspondence between the two series provides the single best measure of what we call a reasonable and sound economic relationship for nonfat dry milk prices between California and the rest of the country.

Those computations and summaries have helped us to calculate the losses California producers have incurred which are caused by the growing price divergence between the CWAP reports and the NASS reports. Although the NASS price series does record current values for nonfat dry milk, we are concerned that that value may be managed by indexing prices for portions of current sales to the prior week's prices. That explains differences between the NASS prices and the spot market prices that are discovered and reported by USDA in the weekly editions of Dairy Market News.

And I want to stop here and make another comment. When I first wrote that sentence and after I read it four times, I still did not recognize the importance of it and the significance of it. I'm going to come back to that later, and I'm going to repeat it right now for emphasis.

The fact that the indexing pricing practice is used by manufacturers nationally to affect the week-to-week prices that places a moderation on the changes from week to week, that explains differences between the NASS prices and the spot market prices that are discovered and reported by USDA in the weekly editions of Dairy Market News, which we take, which the industry takes to be current values.

I'll continue. The calculation of the losses is straight forward. Although the spread between the national prices and the California prices started to appreciably widen by October 2006, we began our measurement of losses with December 2006.

In order to arrive at the current total, we included the month of July 2007, using July 2007 price differences buy July 2006 pool solid usages as an estimate for 2007. The 2007 July figures may be available today. I certainly think they would be available within the ten-day time filing brief period in which case we would modify these figures and incorporate them into our presentation.

We have taken the difference between the NASS prices and the CWAP prices that are included in the document entitled, "Various NFDM/CMP Prices Monthly and Annual Averages 2002 to 2007." This was a document that was reviewed at the workshop 14 days ago. It was prepared by CDFA and reviewed at the workshop meeting on August 14th. And we applied those differences to the solid nonfat pooled usages in Class 1, 2, 3, and 4a respectively for the time period specified in the various price formulas. The results of these calculations are shown in the following table.

We take no pleasure in presenting these numbers. The money is lost. It will not be recovered. The figures for August and September and possibly October will be added when it is time. It looks like California producers have been financing construction of a drying plant and have got nothing in return.

The purpose for getting these numbers into the record for this hearing is to show what can happen and what has happened when an organization that controls about 90 percent of a closed market has no accountability for its actions.

The table that follows is entitled, "Impact on California Producers," resulting from differences between the NASS nonfat dry milk prices and the CWA prices for the period December 2006 through July 2007. I've listed the computations on a month by month basis. There are eight months totaled. Just to save a little time, I will round these figures. I'll give you the total.

For December 2006, it was $10,100,000.

January 2007, $10,900,000.

February $10,800,000.

March, $13,600,000.

April, $18,900,000.

May, $32,900,000.

June, $49,300,000.

July 2007, again using July 2006 volume, was calculated to be $37,800,000.

The total, $184,467,737.

As we said, we don't have the actual July figures yet. The differences will affect August and September and again possibly October.

So that identifies a cost to producers for this relatively short period of time because of the difference between the NASS prices and the California weighted average prices.

The second question I have been asked to look into is to try to find a reason why the CWAP series fell so far below the national average price series so fast. Milk Producers Council began to closely follow the widening price difference which began in the middle of 2006. The price spread began to widen in June and July by slight amounts from month to month and continued through the end of the year, at which time we believed it had reached about four-and-a-half cents per pound difference compared to the seven-hundreds of a cent difference that the California Department of Food and Agriculture has calculated for those four years.

We did not know at the time that millions of pounds of nonfat dry milk sold under long-term contracts were being incorrectly reported to NASS. Only those plants, companies, sales agencies, whoever was reporting the prohibited sales, knew the real difference. How much that affected the week to week prices that were carried forward through the price indexing practice that we have mentioned, no one knows.

The differences between the two major price series continued at about the same levels they had reached in October until March, when the price spread reached what we believed to be about five-and-a-half cents per pound.

Meanwhile, the normally close relationship between the central and western mostly series discovered and published by Dairy Market News on a weekly basis began to widen during that period of time to more than 41 cents per pound in November before it fell back to 10 cents per pound difference in March. And I note by July they have reached essential parity.

It was only after a letter was sent to the Office of the Inspector General in February of 2007 by an industry organization by that NASS formally questioned the sales price it had been receiving. That inquiry resulted in a correction of four weekly sales reports, which is the furthest back they are allowed to restate previously submitted reports, and gave the industry a brief look at the levels of nonfat dry milk prices that are sold under long-term contracts. And later on we received a much more lengthy and detailed list of those exported prices.

The corrected price reports resulted in a re-statement of the March NASS prices. The five-and-a-half cents per pound difference we had been looking at and thought was correct was immediately restated to about twelve-and-a-half cents to 13 cents per pound difference. And the reason for that, just to explain, NASS when they received the corrected -- when they asked their nonfat dry milk reporting agencies to review their reports to verify that no sales beyond the 90-day limitation that was imposed were included, they received an immediate result and adjusted the three weeks, the week they had and three weeks earlier. That was as far back they could go. So again, the five-and-a-half cents per pound we've been looking at that included long-term contract sales was immediately restated by USDA to twelve-and-a-half cents per pound.

Thereafter, the difference between the two monthly averages continued to widen. It reached about 18 cents in April, 29 cents in May, 43 cents in June, and 21 cents in July. The difference between the CWA price and the western mostly price also widened. In May, it reached 42-and-a-half cents per pound, and in June, 64.13 cents per pound.

And here I want to go back to the statement I made I think on the first page. The reason we believe why the mostly prices, which are reported on a weekly basis, and discovered by USDA and reported in Dairy Market News are current prices, they talk to buyers and sellers and evaluate offers. And they calculate the majority of sales during that period. Not necessarily the weighted average, but the majority of sales. In this case, it would be in the western region. And that western region includes eleven western states. It widened.

And why? Because the mostly prices are a weekly basis reflecting almost immediately current market conditions and changes in those conditions. The NASS prices and certainly the CWA prices also reflect an end procedure. The CWA prices have to be the start at the time the NASS prices had been corrected, and all long-term contracts sales that were prohibited from being reported were, in fact, left out. And still they lagged far beyond the CME mostly prices for the very reason that those prices are indexed from week to week which flattens out the changes. And when there is a sharp period of change in prices and supply and demand conditions, the NASS prices do not reflect those.

We believe we had the answer to the question, why? Huge amounts of nonfat dry milk priced under long-term low priced contracts was being reported to CDFA by California plants. To estimate just how much that was, a simple program was devised. It contained what was known about nonfat dry milk production, sales volumes, prices, and exports. What was not known was filled in by what we believe to be reasonable assumptions and estimates. A list of the data sources and assumptions used to arrive at our estimates is attached to this testimony. The model tells us what could have happened, given the assumptions made.

I'll point out here there was a little lack of communication between Mr. Vanden Heuvel and I. The attachment here is really -- does not really contain the assumptions made, and I apologize for that. And I apologize also for not bringing them with me. It was a different document that had referred to a different analytical procedure. But I'll try to remember what the assumptions were made.

First, we assumed -- what we know was the total amount of nonfat dry milk exported during a period during a month as reported by USDA. We knew what the California plants reported in terms of volumes and a weighted average price. And from that, we could calculate the total dollar amount.

We assumed that the California plants who exported sales or reported sales that were exports did so at the average price reported by USDA/FAS on a monthly basis.

We also assume domestic sales made by California nonfat dry milk plants were made at the NASS prices. We also assumed that based on information we have heard over the years that the manufacturing plants who are members of a major California sales agency represent about 90 percent of production.

Another assumption we made based upon information we have gotten from a number of sources is that we made a best estimate that about 15 percent of all exports of nonfat dry milk made during a year over time, about 15 percent is made by plants who are not members of this major sales agency.

There may be more, but I will provide that list in detail in our brief. But that I believe accounts for all the assumptions. And I apologize for the misunderstand we had here.

The conclusions are these.

1. Over the period December 2006 through June 2007, which was the latest figures available, California plants produced 54.4 percent of the U.S. production of nonfat dry milk. Assuming member plants of the state's major nonfat dry milk sales agency produced 90 percent of the state's production, their percentage of U.S. production then averaged 49 percent for the period.

2. Of the total pounds of U.S. nonfat dry milk exports during the period, California plants could have

accounted for 75.2 of the total. Because it is believed that the major California dairy product sales agency is the only exporter of nonfat dry milk produced in California, that sales agency therefore could have exported all of the exports from California, namely 75.2 percent of the U.S. exports.

3. Our best estimates based upon discussion with a number of people in industry and government positions is that about 15 percent of U.S. exports of nonfat dry milk are made by plants that are not members of a major sales agency to which we have been referring.

Following along with the numbers and the logic, that means that the California plants who are members of the major sales agency could have exported 88.5 percent of the total amount of nonfat dry milk that was exported by that agency for the entire U.S. That is what we refer to when we allege that a disproportionate amount of low priced exports are being borne by California.

And at this point when I wrote that sentence and realized what it meant, a cartoon came into my mind. And that cartoon was, in effect, a hay wagon leaving a barn and children from all over the area jumping on top of it. The California exports of nonfat dry milk has been a hay wagon attracting volume products from all other plants that are jumping on the band wagon because California can really be exempt from incurring cost for making those products.

Number four, the decision to assign a disproportionate amount of its low-priced long-term contracted sales to its California plants makes good business sense for that sales agency, because those prices are combined with its domestic sales, and they translate directly into its cost of milk for those sales.

To illustrate and validate the above point, the volumes and prices for March 2007 will be used. California plants in March 2007 reported sales of 66,595,600 pounds of nonfat dry milk at an average price of $1.1353 per pound. That generated $756,605,985.

USDA/FAS reported that 47,816,003 pounds were exported that month at an average value of $1.0353 per pound.

The NASS price, after stripping away the long-term exported product during that month, averaged $1.2595 per pound that month. The only combination of exported volume at the declared value for exports and the domestic volume at the NASS prices that will equal the California volume and value totals 36,887,482 pounds of product exported and 29,708,188 pounds sold domestically at the NASS prices.

The 36,887,482 pounds for exports that were charged to California plants under this computation represented 77.1 percent of the total pounds exported during the month. Similar computations were made for each of the other months.

A look at what happened a year earlier shows about the same value of nonfat dry milk was exported, but at a somewhat lower price than this much. The volume was 51.3 million pounds, the average value for those exports were declared at 94 cents per pound. These are rounded figures. However, the calculation outlined in the preceding paragraph for March 2007 cannot be done for 2006, because the CWA price and NASS prices for the month of 2006 were both lower than the export prices at 84 cents and 87 cents per pound respectively.

And we ask now how can that happen? The answer to that question can only come from the parties directly involved in the transactions.

There is another aspect to the issue of nonfat dry milk prices sold for expert purposes: Discovery of the prices. First, validation of the prices. First, the prices FOB ports in major trading countries reported by USDA/FAS on a biweekly basis are considered by USDA to be very valid.

Second, the low end of the range of those prices are consistently well above the prices. Let me repeat.

The low end of the range for those prices are consistently above the prices that are reported for U.S. exports of nonfat dry milk.

Third, the brief look at the specific prices for nonfat dry milk exported under long-term contracts taken from NASS's special report of the corrected sales figures validates the prices reported for exports of nonfat dry milk.

To summarize, this means that the prices reported by the plants coincide with the prices reported by the Department of Commerce and Ports of Exportation Embarkation, and they both are well below the low end of the prices reported for ports FOB in major trading countries.

What conclusions can be drawn for this discussion? First, it's clear that immense profits are being made from selling nonfat dry milk for export purposes, but milk producers in California and nationally are not on the receiving end.

Second, the spot market mostly price series appear to be a much better gauge of current prices than price surveys.

Third, interstate entities that have the ability to share costs and revenues on a nation-wide basis on an interstate basis.

Fourth, California has been used as a dumping ground for clearing below-market priced nonfat dry milk.

Fifth, the major California sales agency for nonfat dry milk has incurred virtually no losses on its sales for export purposes.

Six, the sales programs used by the major California sales agency are good business decisions for that sales agency.

Seven, unless something is done in California to either control what is reported in the way of nonfat dry milk sales or unless the basis for determining the cost of milk used to produce nonfat dry milk is changed to an independent source, California producers will again be the ones who will be told to pay the price for selling the product at cut rate prices.

Eighth, the present basis for setting Class 1, 2, 3, and 4a milk price on the skim side is not sensible or supportable under current market conditions.

MR. VANDEN HEUVEL: It is imperative that there be change to the current system. The question is what change should be made.

Of all the commodity prices used in the California pricing system, the 4a formula's dependence on a California plant survey price is unique. We understand that there are only two organizations which report powder sales to the Department. We are told that one of these organizations makes up about 90 percent of the volume of the powder that gets accounted for in that survey. In essence, the structure of the California system allows that powder maker to transfer the entire risk of their marketing decisions to all of the California's producer through the 4a formula and pooling system.

In the June 2006 Class 4a, 4b hearing, Mr. Joe Heffington representing California Diaries testifying about the CDFA butter survey and the concerns he had with it on page 158 of the transcript said the following, "The only explanation appears to be the forward pricing sales have been included in the CDFA reports. If this is the case, we do not believe that these types of sales should be included. We do not believe it is reasonable for dairymen to take the risk for forward priced sales by manufacturers."

We couldn't agree more. But at least in the case of butter, any distortion that may have occurred because of forward priced sales could not influence prices in real time, because it is the independent Chicago Mercantile Exchange that drives the butter formula. Changes to the adjuster which could be influenced by forward-priced sales happens occasionally and then only after a hearing. In the case of powder, the influence of forward priced sales is hard wired into the real time price that this very entity has to pay for milk.

We anticipate a representative of this major powder maker will testify today that there really is no problem with the current system. They will argue California needs to export powder out of the country and that means long-term contracts must be used. They will make the point that California producers should be happy to absorb the risk associated with serving this growing market.

We respectfully suggest that if they really believe this, then they should go to the Legislature and change Section 62062 of the Food and Agriculture Code. In our view, it is illegal for the Secretary to establish a milk pricing formula that exposes California producers and processors to a minimum price that is totally out of line with the national value of manufactured milk products.

In Milk Producers Council's view, using a California-only plant survey when there are only two organizations reporting and one makes up 90 percent of the volume in the survey is inherently flawed and not appropriate for usage in the Class 4a formula. Recent history has vividly demonstrated the abuse that can happen to California producers when the system essentially inoculates the sellers from the price risks associated with their marketing decisions.

We are proposing to use the simple average of the nonfat dry milk west mostly prices as published in Dairy Market News. This is the same procedure that California currently uses to establish the dry whey product value for usage in the 4b formula. The purpose of the Dairy Market News price surveys is described in a recent report put out by the Seattle Federal Market Administrator's Office, which is Exhibit 7E, as, "To provide current, unbiased price and sales information to assist in the orderly marketing and distribution of farm commodities."

We believe use of the Dairy Market Use's weekly nonfat dry milk west mostly price report is the most appropriate basis to use for setting California's Class 4 minimum prices. The reason for that is that it is independently determined by USDA and reflects the majority of sales and offers to sell that occur weekly in the eleven western states. The average of this price report rarely differs from central mostly report by more than the cost of transportation between these two areas. Use of it would give California producers the reassurance that the market is serving to set their milk prices rather than a survey of prices that can be managed by indexed pricing or by timely sales activities.

CDFA has calculated the affects of using our proposed price report and has shown there is relatively little total effect. The pluses would seem to far outweigh the negatives. This is the type of information we should be looking for to establish the product values that should drive our California milk pricing formulas. We have it in butter and cheese product values with the Chicago Mercantile Exchange prices. The Dairy Market News dry whey price provides it for the 4b formula, and now we need to adopt the Dairy Market News nonfat dry milk price to establish the powder product value in the 4a formula.

Because the Class 1 formula also includes the usage of the current faulty California powder survey if a change is made to the product value formula used in Class 4a formula, a similar change needs to be made to the Class 1 formula.

Other proposals. All of the other proposals seek to fix the current plant price survey system. We are skeptical they can be sufficiently fixed to remove the biases and distortions that come from the current reality in California where one organization controls 90 percent of the volume of the product in the survey.

We understand that the price formulas in the federal orders are driven by product values established by the plant surveys developed by the NASS. These certainly are indications of the national value of managed milk products, which Section 62062 of the California Food and Agriculture Code requires the Secretary to pay attention to.

If the Department decides to continue to use a California plant survey price in the 4a formula, then the reporting procedure must be changed. MFC believes the Dairy Institute alternative proposal comes the closest to lining up the California reporting rules with the NASS reporting procedures. We would therefore reluctantly support the Dairy Institute alternative proposal in total, even though it does nothing to address the narrow volume base of the California survey.

That concludes our prepared testimony, Mr. Hearing Officer.

HEARING OFFICER CLEARY: Thank you, gentlemen.

At this time, I'd like to ask the Panel if they have any questions of the two witnesses.

PANEL MEMBER GATES: I have a couple. Mr. Vanden Heuvel, I have a couple of questions for you.

On page 7, you're referring to the way butter is marketed compared to nonfat dry milk. Do you feel they're similar in the way they're marketed?

MR. VANDEN HEUVEL: Are you referring to something that I may have said in the testimony?

PANEL MEMBER GATES: Yes.

MR. VANDEN HEUVEL: What are you referring to?

PANEL MEMBER GATES: I'm referring to Mr. Heffington's testimony.

MR. VANDEN HEUVEL: Oh --

PANEL MEMBER GATES: I think you were comparing it.

MR. VANDEN HEUVEL: Well, butter is sold, and powder is sold. And I think what Mr. Heffington was referring to was the sales -- plant survey price that we do, CDFA does. And I do think that butter is sold from time to time internationally as well as domestically. These markets ebb and flow. They're obviously not identical. But it's a bulk dairy commodity product. And, yes, I think there's great similarities in the way butter, cheese, nonfat dry milk, whey, all these commodity products are sold in large quantities all over the world, but domestically as well.

PANEL MEMBER GATES: And secondly, at the bottom of page 7, when you're referring to the mostly price -- and you were saying -- I guess what I'm asking in that one is, do you know how many entities report to that pricing series that you're proposing?

MR. VANDEN HEUVEL: I do not know.

John, do you?

MR. KACZOR: I've talked to USDA people on a number of occasions and asked what goes into those reports. And they say they have regular contacts in each of the areas including manufacturers, resellers, warehouses, buyers. And they also pick up offers to buy. Offers to sell, offers the buy.

They don't identify the minimum, the number. But they say that represents the majority of the individual sales during that weekly period. It does not -- it is not weighted average. It simply identifies the sales made within the ranges that they report.

PANEL MEMBER GATES: And they don't release how many entities that represents?

MR. KACZOR: I think they prefer to keep the contacts confidential. And they really have no way of weighting -- identifying the volumes or weighting them. That's why these are always simple averages. The same applies for whey, for example.

MR. VANDEN HEUVEL: If I could just -- I think what -- you know, the Department ran back in history a comparison between these various price series. And you see a close correlation between the Dairy Market News' numbers and the NASS numbers and the CWAP until we experienced the last eight to ten months. That's when they deviated. That's really a check on how accurate is this information. How much confidence can we have in it.

You know, frankly, we would prefer to use an exchange price. But the exchange -- Chicago Mercantile America Exchange price for nonfat is still too thin to be used as -- it's a little premature to try to adopt that. Ultimately, we would hope that that's where we would go.

And I guess you have to compare -- it's important, Ms. Gates, that we don't have a perfect solution. But the situation -- the whole point of the first half of our testimony is that the current situation has been a disaster. And that is the point that the Hearing Panel needs to recognize. There must be change. We're offering up this. Other people have other suggestions.

PANEL MEMBER GATES: So you're saying Milk Producer Council's confidence is more in this price series.

MR. VANDEN HEUVEL: We need a current market price. We need a current market price. We recognize that what the Secretary is establishing, everything that we are doing in this hearing process, has to comply with the law, the guidance that the law gives us.

And the touch back -- we make a big point of this. We don't think this can be overlooked or ignored. The Secretary can't ignore the law any more than any of us can. It has to be in a reasonable and sound economic relationship with the national value.

And there are problems with the NASS. John talked about the indexing, and there's lots of controversy about the NASS. They're going through their own. But the NASS -- you can make a reasonable case that that reflects a national value for product. So if they got problems and we are close to them, I mean, we all got problems together. Our suggestion is to go to the Dairy Market News.

PANEL MEMBER GATES: Thank you.

MR. KACZOR: I'd like to add one more comment to that. I mentioned in my testimony that the agricultural marketing service as a point of principle wants to have current market values. That is why they have instructed NASS to include that prohibition against sales that go beyond the 30-day period and that have not been adjusted. They want current market values to be used in the USDA federal order price formulas. And so we're looking at current price formulas. The NASS price series has been corrected and verified. It seemed to do that, although it has a limitation on the indexing of prices. And the most current reflection of values is certainly in the NASS mostly -- in the USDA's mostly reports.

PANEL MEMBER GATES: Thank you.

HEARING OFFICER CLEARY: Any further Panel comments?

PANEL MEMBER IKARI: Just have a couple of follow-ups.

Mr. Kaczor, you indicated you made some assumptions you didn't bring. Are you going to include that in your post-bearing brief?

MR. KACZOR: Thank you. I have looked through the attachments here, and there are two lists of assumptions or information. It turns out my assumptions have been included. It follows the last page of Mr. Vanden Heuvel's testimony. It's entitled, "Estimated Amounts of Nonfat Dry Milk Sold for Export Purposes by California Manufacturing Plants for the Period December 2006 Through June 2007, Data Sources and Assumptions." It is those seven assumptions, identification of data and assumptions made that I've been referring to. And I apologize for misstating the situation earlier.

PANEL MEMBER IKARI: Okay. Finally, you mentioned the Dairy Market News. I wondered if you can get some documentation on the process/procedures from USDA as to how that survey is conducted.

MR. VANDEN HEUVEL: We will attempt to.

PANEL MEMBER IKARI: And include that in your post-hearing brief. Thank you.

HEARING OFFICER CLEARY: Any other questions from the Panel?

PANEL MEMBER GOSSARD: First, more of a procedural question. You both made allusions to the post-hearing briefs. I don't believe either of you requested to file one.

MR. VANDEN HEUVEL: Mr. Hearing Officer, I would request that John and I be given permission to submit a post-hearing brief.

HEARING OFFICER CLEARY: Thank you for the recommendation.

MR. KACZOR: And with respect to that --

MR. VANDEN HEUVEL: Wait a second.

HEARING OFFICER CLEARY: I'll make a decision as to the post-hearing at the conclusion of the hearing. At that time, I'll make a determination if and when whether or not we need to do that.

MR. KACZOR: Thank you. I would just add if, in fact, you do permit post-hearing briefs, our testimony has spoken in detail about what we are proposing. Mr. Vanden Heuvel has referred to other proposals. And I think Dairy Institute, when they made their presentation, they will raise more issues having to do with recording procedures, products to be included, and time limitations and so forth. Because Mr. Vanden Heuvel mentioned that as an alternative to ours if it is decided to be used, the Dairy

Institute proposal would be most appropriate, and we might want to make some comments on that and on Western United proposals. So we hope it would not be limited to anything we did not say, because our interest is in every aspect of matters that come up in this hearing.

HEARING OFFICER CLEARY: Thank you. For the edification of everybody else, I'm allowed to allow up to ten calendar days for comments at the end of this hearing. It's up to ten calendar days. Depending on whether or not I determine you need ten days, it's up to the Hearing Officer to decide that based on the testimony that's given. That's why I decided to hold off on ruling until the end of the hearing itself.

But your comments are absolutely welcome, given the fact you're not going to know what anybody says until they say it. So thank you.

Any other questions from the Panel?

PANEL MEMBER GOSSARD: Mr. Vanden Heuvel, on page 2 of your testimony in the center paragraph, last sentence, "Unfortunately for California producers, the negative impact of these long-term contracts was multiplied because research shows a disproportionate amount of California powder was exported well below." Was that statement based on the analysis done by Mr. Kaczor?

MR. VANDEN HEUVEL: Yes.

PANEL MEMBER GOSSARD: On page -- I'm sorry. I thought I had one more question for you. But I guess not.

Mr. Kaczor, on page 3 of the testimony, the NASS report since its beginning has been considered to be the most objective measure of the current national value of nonfat dry milk. You made mention of the index contracts that exist both in the NASS and the CWAP. Is it your belief that the NASS price is used for indexing? And if so, do you have any basis for that?

MR. KACZOR: I don't believe it's used for indexing. I believe indexing is used by the practitioners. And that is information that we have received. And perhaps Mr. Vanden Heuvel can elaborate more upon that, because he has more sources and have heard more comments regarding that.

PANEL MEMBER GOSSARD: Mr. Vanden Heuvel, when index contracts are set, are they often tied to the NASS price?

MR. VANDEN HEUVEL: I have been told by sources that I consider to be credible that the NASS price series is used as an indexing indices.

PANEL MEMBER GOSSARD: Okay. On page 5 of your testimony, Mr. Kazcor, point 2, the total pounds California could have accounted for 75.2 percent of the total. How was that number arrived at?

MR. KACZOR: I'm going to have to think just a moment. It is a result of the computations we made in reconciling. I went through the example for the month of March. We start with the reports by the California plants, volumes and a price, which is weighted price, multiplying the one by the other comes to total dollars that has to be reconciled and the total pounds have to be reconciled.

And there's only one -- and now again the assumptions are important. We assume that the export prices on sales made by California plants for export are equal to the average price for the month for exports. We also then assume that the domestic sales -- that is, the balance of nonfat dry milk sold that is not exported -- is sold at the NASS price. And there's only one combination of export price volumes and the export price and domestic sales at the domestic price that will come back precisely to the volume of milk reported by California producers and the specific total dollar amount. And we calculated that for the seven months, and that is what we base our conclusion on.

Now, the assumptions are assumptions. And we don't know, nor apparently does the Department of Food and Agriculture know, just how much of the sales reported by California plants and particularly by a major sales agency for California plants are exported. But we simply made the calculation. These could be the numbers if the assumptions are correct. If the assumptions are not correct, we invite others to provide the correct figures and provide those amounts for the record.

But it is certainly clear to us that California is the major sales agency for California, which also is a major sales agency for the entire U.S. And they have plants throughout the U.S. California is being used for the majority of those sales well beyond their percentage of production of U.S. production of nonfat dry milk, because they can report those sales at the low price and those sales are prohibited from other states.

So either the product is flowing in and transfers are being made out or the sales are actually being made from California manufactured products or a combination of the two. And there's also an overriding consideration as to how much, if any, the national major trading agency compares or shares costs and revenues. It is defined as a marketing agency in common. And we have been told many times over that there are two principles from marketing agencies in common: Shared costs and shared revenues and being committed.

And a comment that I heard almost in disbelief from one of my contacts in USDA was, "Well, they've got to be sharing revenues." Or with respect to the person, the entity they sell to, because there's huge profits incurred by that entity based upon the sales reports for exports. Or there's got to be sharing of information among all plants within that major sales agency. That was his belief. He assumed it. And that's why I included one of the conclusions among my eight conclusions that could be done.

PANEL MEMBER GOSSARD: My final question is on page 6, the second paragraph. You were making a comparison that B prices over C's to what is basically the U.S. prices. In making those comparisons of the differences, did you make any adjustment for transportation cost differences from those ports to the buyers?

MR. KACZOR: I made an adjustment first to the prices, the average value of the average prices that USDF/FAS reports on a monthly basis for the volume of product exported. And I deducted one-and-a-half cents from that to allow for the fact that, by definition, the sales are supposedly made at a manufacturing plant, at which time the transfer of title changes. There are costs for getting that product from that point, transporting it to the port of embarkation, and loading it on the transport ship. Those are borne by the seller, at which time the legal responsibility for the product changes to the buyer. They must insure and they must incur all the additional costs.

In talking with the USDA representatives who are knowledgeable about exports, they say that the competing entities in the Western Europe and Oceania bare those same costs. So at the point of embarkation there should be uniformity. That's why I made that adjustment of one-and-a-half cents, 600, 700, 800 dollars to allow for that.

With respect to the shipment, I'm told once the product is on the ship and the ship actually departs, there are costs per nautical mile. And so there is some variation. It depends where the products go. For example, California export to Mexico would have a very relatively short, small cost transportation. If we ship product to Indonesia, there is a relatively long shipping cost export from Oceania have also a cost. There would be a minor difference.

But what we've looked at is differences as much as 80 cents. That's on the low side. The low end of the range. Not anything above. And the prices for export from the U.S. are well below the low end of the range. So I think there is plenty of allowance for those kinds of things. And even after those allowances, there's many millions of dollars of profits made, and they're not being enjoyed by California producers or U.S. producers.

PANEL MEMBER GOSSARD: No further questions.

HEARING OFFICER CLEARY: Anyone else on the Panel with any additional questions?

If not, at this time I'd like to thank the two gentlemen, and you are dismissed at this time.

MR. KACZOR: Do we have any more time for direct testimony?

HEARING OFFICER CLEARY: Four minutes left.

MR. KACZOR: Do we -- could we --

MR. VANDEN HEUVEL: You can sign in.

MR. KACZOR: Thank you very much.

HEARING OFFICER CLEARY: All right. At this time, I'd like to call representatives from the Dairy Institute. The Dairy Institute and the Alliance have submitted alternative proposals, and each one of them will be allowed 30 minutes to make presentation.

Thank you, sir. May I have your state your name, affiliation, and spell your last name for the record, please?

MR. SCHIEK: My name is William Schiek, S-c-h-i-e-k. I'm with the Dairy Institute of California.

HEARING OFFICER CLEARY: And do you swear or affirm to tell the truth and nothing but the truth today, sir?

MR. SCHIEK: I do.

HEARING OFFICER CLEARY: Thank you very much. You may proceed. Was it your intention to have your written testimony entered into the record?

MR. SCHIEK: Yes, it was.

HEARING OFFICER CLEARY: The written testimony of Mr. Schiek will be labeled Exhibit Number 48 and entered into the record as such.

(Thereupon the above-referenced document was marked as Exhibit 48 for identification.)

MR. SCHIEK: Thank you.

Mr. Hearing Officer and members of the hearing panel, my name is William Schiek. I'm an economist for Dairy Institute of California, and I am testifying on the Institute's behalf.

Dairy Institute is a trade association representing 40 dairy companies which process approximately 80 percent of the fluid milk, cultured, and frozen dairy products, around 70 percent of the cheese and whey products, and a small percentage of the butter manufactured in the state.

Member firms operate in both marketing areas in the state. The position presented at this hearing was adopted by the Dairy Institute's Board of Directors.

Dairy Institute appreciates the opportunity to testify at this hearing in support of our alternative to adjust California's weighed average nonfat dry milk price calculation. We also thank the Department for the opportunity to comment on the petitions submitted by Milk Producers Council and Western United Dairymen and the alternative proposal by the Alliance of Western Milk Producers, which are also under consideration at this hearing.

At issue in this hearing are proposed changes that will affect the price of nonfat dry milk that is used in establishing Class 4a and occasionally Class 1 solids nonfat prices, and by reference Class 2 and 3 solid nonfat prices.

The particular commodity price that is used in the end product pricing formula is of paramount importance in establishing valid market-based prices for producer milk. If the price is not sufficiently reflective of current market conditions in the end product market, the milk price generated by the formula will not send the appropriate economic signals to producers. This pricing inefficiency can lead to situations where milk output flows are not in line with market demand and to increase in price volatility that create difficulties for both producers and processors.

In establishing pricing formulas, the Secretary is directed by the Legislature to weigh the factors found within statute. The California Legislature has declared that milk production and marketing is a business affected with a public interest. Therefore, the dairy programs must be operated so that the public interest is served.

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

With regard to class prices, the Secretary has been directed by the Legislature to ensure that the prices for market milk bare a reasonable and sound economic relationship to each other and to the national value of manufactured milk products. The Secretary is also directed to conform the pricing standards governing minimum producer prices for market milk to current economic conditions and to consider any other relevant economic factors in setting milk prices that are not explicitly set forth in the code.

Over the years, the California weighted average price for Grade A and Extra Grade nonfat dry milk appears to have worked well in its role as the primary constituent of Class 4a price determination. Historically, there has been relatively little reason to suspect that the California weighted average price was not indicative of recently current market conditions.

As shown by the Department's pre-hearing workshop analysis, the CWAP, the National Agricultural and Statistics Services, or NASS, nonfat dry milk price and the Agricultural Marketing Service's Dairy Market News western nonfat dry milk price have tracked reasonably closely since 2002. However, beginning in late 2006 and continuing into 2007, the CWAP and NASS prices began diverging, culminating in an average price difference of almost 43 cents per pound for the month of June 2007.

In July, the gap between the two series narrowed to around 21 cents per pound. And for August, it is expected to narrow still further to around 9 to 11 cents per pound.

Still, the structural differences in the methods for determining the value of nonfat dry milk in the California Class 4a formula and the federal Class 4 formula continue to exist. Therefore, prices could diverge again in the future. In light of this possibility, it is entirely appropriate that we consider whether or not changes to the current method of determining the California nonfat dry milk price are warranted.

It is our view that the prices used in the Class 4a and Class 4b price determinations should reflect current market conditions to the extent possible. In comparing the CWAP to the NASS price for nonfat dry milk, it is clear that NASS prices, which exclude forward fixed price contract sales more than 30 days old, are likely to be more representative of current market conditions than are CWAP prices.

That said, we want to be clear that we believe the CWAP has performed admirably over the years. It cannot be doubted that the Department has constructed a price series that has fairly represented the prices received by California plants for their sales of nonfat dry milk. The completeness of the survey, along with the ability that CDFA has to audit the data reported by the plants, has led to, we believe, a far more accurate picture of California nonfat dry milk price levels than can be obtained by any other method. So while we believe changes are needed to the CWAP to ensure that the series more fairly represents current market conditions, we are by no means suggesting eliminating the CWAP or adopting some other price series as our basis for establishing California milk prices.

Dairy Institute's proposal does not amend the stabilization and marketing plans, but rather it changes the specifications for the product to be included in the weekly and monthly nonfat dry milk sales reports which form the basis for the California weighted average price. Again, we are not proposing to replace the California weighted average price, but rather to alter the products to be included when calculating the price.

We do not feel that the changes we are proposing need to be included in an amended stabilization and marketing plan, but rather they should be adopted administratively.

Dairy Institute proposes that the pricing specifications set forth in the recent interim final rule by USDA's agricultural marketing service pertaining to the dairy product mandatory reporting program be utilized in the weekly and monthly California nonfat dry milk sales reports. These specifications which became effective August 2nd, 2007, and are currently utilized by NASS in its survey of nonfat dry milk prices are listed below. These were included in our alternative proposal, so I am not going to read everything. But you'll note that there's a definition of how a sale is defined as well as the containers that are to be included. It talks about including low and medium heat process powder as well as CCC purchases under the support program. And it talks about excluding nonfat dry milk more than 180 days old.

That nonfat dry milk manufactured using high heat processes and more specifically the exclusion of forward pricing sales where the selling prices are set 30 days or more before the transaction was completed.

Adoption of these specifications will provide three main benefits:

A more transparent milk price determination;

A more predictable basis between federal and California raw product costs with respect to Class 4a 3, 2, and Class 1 products;

And an additional incentive for suppliers of nonfat dry milk to utilize the futures market which would increase market liquidity for the benefit of all industry participants.

A more transparent milk price determination. Under the current specifications that the Department employs in constructing the CWAP series, forward fixed price contracts are included regardless of the age of the contract or when the price applicable to the nonfat dry milk shipments was set. In practice, when there are a lot of export sales, California plants may deliver on a number of contracts for which the fixed price was set at different times. Under these circumstances, market participants have no idea what the CWAP price will be or even whether it will increase or decrease, because the price is a function of how much volume is delivered on each contract in a given week or month.

The result is somewhat chaotic for buyers who are trying to budget and plan for what their costs will be. For example, in late June, while the price for nonfat dry milk reported by NASS was increasing steadily and rapidly, the CWAP price fell by more than ten cents per pound. During the following week, the CWAP price increased by almost 47 cents per pound.

Volatile price movements such as these send improper and confusing market signals to both producers and processors and can cause them to make impossible economic decisions. Suppose the market has a high demand for nonfat dry milk and dwindling supplies. Price is the mechanism by which this information is ordinarily translated to the marketplace. And it therefore must represent current conditions to the extent possible.

If an artificially low price, one that is held down by long-term fixed price export contracts, causes a buyer to use nonfat dry milk more freely because he or she perceives the price to be low and the supply abundant, then the market supply deficit is made more acute. The marketplace will then see prices move higher than they should have, which will cause buyers to cut back on purchases more than they would have had proper market information had been transmitted into the marketplace. Adoption of the Dairy Institute proposal will create more transparency in California milk price determination and prevent such problems.

A more predictable basis between California and federal prices. Greater consistency between California and federal order pricing will provide for fewer disruptive marketing conditions.

I wanted to depart from my written testimony just a minute to talk a little bit about what we mean by consistent. When we say consistent, we're not talking about equal price levels between California and federal orders. We believe that local supply and demand conditions can dictate that California price could or should be higher or lower than comparable federal prices. For us, I think consistency means that the primary mover of milk prices should be consistent between the two systems, unless there is a compelling economic reason or overwhelming market concern to do otherwise.

Wide differences in the nonfat dry milk prices used in California and federal orders lead to large differences in milk costs. When such differences exist, there can be economic incentives to move product and/or milk components between California and federal order plants. Under California's advanced two-month pricing for

Class 2 and 3, California prices lag federal prices. At times, arbitrage opportunities do exist, but they are predictable. A cost advantage in one system is followed by a cost advantage in the other, according to a fairly transparent pattern. However, when the basis of pricing diverges, as it has this year, the incentives to move product or components between California and federal plants can become magnified.

During the first half of the year, California Class 4a skim has been priced lower than the federal skim. California nonfat solids have appeared relatively cheap to plants outside the state. This has actually been helpful this year, as limited plant capacity has made it challenging to clear the California milk market. Now suppose that in the coming months fixed priced contracts hold the CWAP price above the NASS price even as the nonfat dry milk market price is declining. As a consequence, California's Class 2 and 3 plants will be facing higher prices in California so they can have tremendous economic incentive to source nonfat solids outside California, displacing local milk and making an already challenging plant capacity problem worse. Adoption of the Dairy Institute's proposal will lessen disruptive marketing conditions that are caused by incongruity between California and federal pricing.

Greater use of futures markets. Operators of plants that market nonfat dry milk internationally might argue that they will have less of an incentive to enter into long-term export contracts if Dairy Institute's proposal is adopted. And therefore, they might have to forgo some export sales they would have otherwise made. This is a concern. However, we believe that nonfat dry milk plant operators need to manage risks in the export market like every other international marketer does.

Futures contracts for nonfat dry milk would provide a way for sellers to hedge their fixed price nonfat dry milk sales. To date, liquidity in the nonfat dry milk futures market has been slow to develop. One of the reasons for this many believe is that the nonfat dry milk producer have shown little interest in making use of these risk management products. The sell side of the market has been lacking. Therefore, buyers of nonfat dry milk who have wanted to hedge their price risk have been unable to do so.

If sellers of nonfat dry milk are exposed on their long-term fixed price export contracts, they will have an incentive to use the futures market to manage this risk and will provide the liquidity to make the futures market viable.

Recent history with the cash settled butter futures contract and the dry whey futures contract has shown these markets can become liquid reasonably quickly when both product buyers and sellers have strong incentives to use the contracts.

Other proposals. Western United's proposal for a 90-day limit on the contracted sales to be included in the CWAP is to be commended for its attempt to accommodate export sales by recognizing that such sales take time to develop. Their proposal is not unlike the comments filed by the National Milk Producers Federation with respect to the NASS nonfat dry milk reporting specifications. However, because of our belief that the commodity prices used in California's pricing formulas should reflect current market conditions and the fact that the NASS specifications currently employ a 30-day limit on fixed price contracts, we cannot support the Western United proposal. We believe our proposal will provide for better pricing transparency and consistency with federal pricing.

The proposal of Milk Producers Council should be rejected. The prices collected by Dairy Market News are rough indicators of the value of nonfat dry milk, but they are incomplete and weight all reported sales prices the same. Thus, a sale for ten million pounds is weighted the same as a sale for 100 pounds. Failure to weight the product prices by the appropriate sales volumes can lead to misrepresentation of the actual price level in the market.

Additionally, because the price reporting is not audited, a morale hazard would exist if CDFA relied on Dairy Market News prices when the rest of the country relies on NASS. For example, other western producers of nonfat dry milk would have an economic incentive to report higher than actual nonfat milk prices to Dairy Market News, because doing so would raise the raw product cost of their California competitors, while leaving their raw product costs which are based on NASS pricing unaffected. Because of the morale hazard issues, pricing California milk using Dairy Market News prices should be avoided.

The proposal by the Alliance of the Western Milk Producers seeks to exclude organic nonfat dry milk from the California weighted average price. While this proposal is logical because organic nonfat dry milk is probably a different product with a different demand and unique price level, the volumes of organic nonfat dry milk are likely so small in comparison to the volumes of conventional nonfat dry milk that they are likely to have a significant impact on the level of the CWAP.

Also, we note that current NASS specifications do not exclude organic nonfat dry milk. So for the sake of consistency with federal pricing, we are not supporting the Alliance proposal. We urge the Department to adopt our proposal instead.

Thank you for this opportunity to testify. I'm willing to answer any questions you may have at this time. I also respectfully request that the Department grant us a period for filing a post-hearing brief.

HEARING OFFICER CLEARY: Thank you, Mr. Schiek.

Do we have any questions from the Panel?

PANEL MEMBER GOSSARD: Yes, Dr. Schiek, on page 3, on point 2, you say we should adopt the NASS quantities of 25 KG 50 pound totes and tanker sales. Does that really differ that much from the California statement that all sizes are included?

MR. SCHIEK: I doubt very much that it does under -- you know, currently or historically.

One point I would make though on that is -- and I believe Tiffany LaMendola from Western United Dairymen also made this point that some of these specifications of NASS aren't really that much different or don't create much of a discrepancy with California the way California currently collects those prices. And I think that may well be true.

But I would say that prior to 2006 probably the way we handled fixed price forward contracts didn't create a lot of discrepancy either. So if the goal is to have a consistent basis of pricing between the two systems, we would probably say let's go ahead and put those specifications into use in California, even if we don't feel like they're needed. Because somebody may invent a new container size and start marketing it. And then we might have a difference in the pricing phases under federal.

PANEL MEMBER GOSSARD: My next question, you want -- the Dairy Institute wants to exclude high heat powder. If high heat powder were excluded from the CWAP, should it also be excluded from the processing cost studies done by the Department?

MR. SCHIEK: I would say that's probably true. If you're going to exclude it, for consistency, you should exclude it in both cases.

PANEL MEMBER GOSSARD: Have you spoken to anyone at the processing cost unit to see if it's feasible to exclude the high heat powder?

MR. SCHIEK: No, I haven't.

PANEL MEMBER GOSSARD: If it's not feasible to exclude high heat powder from the processing cost studies, would you still support removing the high heat powder from the report, the CWAP?

MR. SCHIEK: I think again, for the consistency of the pricing, I would say probably we would live with that.

PANEL MEMBER GOSSARD: Finally, this is more of a general question. At the top of page 2 when you're citing the Food and Agriculture Code, you mentioned current market conditions. In terms of current, do you think current conditions are daily weekly, monthly, annually?

MR. SCHIEK: Yeah. I think the Secretary certainly has some leeway in regards to current market conditions. Obviously, we price milk monthly, not daily. So monthly would appear to be an appropriate time frame. And therefore, the 30 days sort of fits in with the monthly notion.

PANEL MEMBER GOSSARD: No further questions. Thank you.

HEARING OFFICER CLEARY: Further questions of the Panel?

PANEL MEMBER IKARI: I have a couple. Dr. Schiek, I'm going to ask a somewhat similar question that I asked Western United.

While the NASS proposed rules do not include 90 days, there is a proposal, as you indicated, that National Milk has made to them. Suppose they change -- for consistency, they change and included the 90 days. Would it be Dairy Institute's position the Department and CWAP should also reflect the 90 days?

MR. SCHIEK: Yeah. When we discussed this in our Policy Committee and with the Board, the issue that was of paramount importance was the consistency of the pricing basis. So based on that, that being the primary issue, we would probably support changing it as well if NASS were to go in that direction.

PANEL MEMBER IKARI: One of the issues that we're both trying -- that we have to deal with is the Department has this hearing in California. NASS is moving -- USDA is moving on their own time frame. We could both shoot in the dark and pass each other along the way.

MR. SCHIEK: I would agree with the statements that Ms. LaMendola made with regard to that. I think, you know, waiting for NASS or waiting for AMS to come up with a decision could be a long wait. It could be a short wait. It could be a long wait.

I think we know they have a program in place through the interim final rule. And I would just advocate going ahead and matching that as our position. And if they change it, then we can come back in and change it. But I think they do have something in place. So we ought to work with that. And we don't know what they're going to do, but it may be a while.

PANEL MEMBER IKARI: Do you have any information that while there's nothing in writing in terms of NASS and the inclusion or exclusion of organic, do you know whether or not NASS is excluding organic regardless of anything in writing?

MR. SCHIEK: I don't know. And quite frankly, if you folks decide that there's sufficient evidence and reason to exclude organic, I don't think we would have a problem with that. I don't think it's a big enough share of the volume that it really has an impact on the price.

PANEL MEMBER IKARI: If we found that NASS wasn't excluding organic, would it make it easier for you to support that position?

MR. SCHIEK: Yes, it would.

PANEL MEMBER IKARI: No further questions.

PANEL MEMBER FRANCESCONI: I have a question for you, Dr. Schiek. On page 3, you have exclude sales of nonfat dry milk more than 180 days old. From an auditing perspective, is there lot numbers that contain date of age of product, or how would one verify somebody selling product over 180 days old?

MR. SCHIEK: I'll be quite frank, I don't know.

PANEL MEMBER FRANCESCONI: That's all the question I have.

HEARING OFFICER CLEARY: Any further questions from the Panel?

PANEL MEMBER IKARI: One question follow up. Dr.

Schiek, have you asked any of the processors about the feasibility -- the administrative feasibility of checking for that, the 180 days?

MR. SCHIEK: No.

PANEL MEMBER IKARI: Okay. Thank you.

HEARING OFFICER CLEARY: If there are no further questions, I thank you, Dr. Schiek, for your testimony. You're dismissed at this time.

At this time, I'd like to call up a representative from the Alliance of Western Milk Producers to give testimony today.

Good morning, sir. Would you please state your name and your affiliation and spell your last name for the record, please?

MR. VAN DAM: My name is William C. Van Dam. I'm with the Alliance of Western Milk Producers. I'm their CEO. My last name is spelled V-a-n, separate word, D-a-m.

HEARING OFFICER CLEARY: Mr. Van Damn, do you swear or affirm to tell the truth and nothing but the truth today?

MR. VAN DAM: I do.

HEARING OFFICER CLEARY: Was it your intention to include your written testimony as well as into the record?

MR. VAN DAM: Yes

HEARING OFFICER CLEARY: The written testimony of

Mr. Van Dam will be labeled Exhibit 49 and included in the record as such. Thank you.

(Thereupon the above-referenced document was marked Exhibit 49 for identification.)

HEARING OFFICER CLEARY: And you may proceed, sir.

MR. VAN DAM: Thank you. Mr. Hearing Officer and members of the Hearing Panel, my name is Bill Van Dam. I'm here today representing the Alliance of Western Milk Producers, of which I am the Chief Executive Officer.

The Alliance is an association of cooperatives that has as its members California Diaries, CDI; Dairy Farmers of American Western Council, DFA; and Humboldt Cooperative Creamery, HCC.

The California members of these three organizations produce a bit more than 63 percent of the milk produced in this state. In the context of this hearing, it is useful to note our members also process at least two-thirds of the nonfat dry milk produced in the state. For the record, it is also useful to note that one of our members, CDI, is nearing the completion of a new nonfat dry milk drying plant in Visalia, which have will a capacity of five million pounds of milk per day.

The concepts presented in the testimony being presented today were approved by the Board of Directors of the Alliance at the July 23rd, 2007, meeting. We are grateful for the opportunity to testify on the reporting procedures used to establish the nonfat dry milk portion of the base price used in the 4a formula.

Changing world. In the past few years, major changes have been occurring in the world dairy trade. Foremost among these changes is the gradually increasing relative wealth of the citizens of the developing nations of many parts of the world, particularly in Asia. With this has come increasing demand for dairy products. At the same time, the Union has trimmed what has been a very generous dairy program, and they are no longer participating in the world market with large volumes of subsidized product. It does not appear they will ever reinstitute a similar program.

The drought in Australia has been going on for years, and it will be a long time before they can recover. In spite of high prices, Australia currently projects decreases of milk production for the coming year.

These factors, plus others, create an opportunity for California dairymen to produce and market nonfat dry milk worldwide. We have a strong belief that the future of California's dairy industry lies in export sales to the west. This state will continue to be important suppliers of product, most notably cheese, to the eastern part of this country. But there is little potential growth in that direction, because that growth can be served economically by the growing milk supplies in Idaho, Texas, and New Mexico.

The demand for nonfat dry milk is high, and the prices are attractive. All indications are that this demand will continue for quite some time, mostly because there are few other places in the world that can respond. The current high milk prices enjoyed by our producers are driven almost exclusively by the worldwide demand for milk proteins.

But being a large scale and long-term marketer of dairy product to the world market is new to our state and to our country. Accordingly, great care must be taken to ensure that our regulations are flexible enough to allow California nonfat dry milk processors to engage in business transactions that will enhance California's position as a reliable major provider of nonfat dry milk and other dairy proteins.

Regulations to the contrary can only inhibit this evolution and injure dairy producers and nonfat dry milk processors. The world, with these high prices, is asking us to supply it with product. Our producers are responding, and our state needs to maintain a regulatory system that allows a sensible economic response.

CWAP. It just so happens that the procedures put together in 1973, 34 years ago, are still a better option for California than any of the new proposals before us today. The basic idea behind the California weighted average price, CWAP, was to use the actual values received by the California plants for standard nonfat dry milk as the basis for determining what those plants paid for their milk. Looking back over the past one-third of a century one has to be impressed by how well this approach has worked for both the producers and the processors.

A review of the CWAP reporting instructions reveals that the instructions are broad and not overly specific. Discretion was left to the Department to determine which products should be included, what constitutes a sale, et cetera. These decisions were made with the active informal support and input from the industry. Changes to the rules were made not by the hearing process, but with the same informal participation of the industry. The required changes were few and far between, and the flexibility served the industry well.

The proposals put forth by others at this hearing would create a regulatory environment that moves away from a system that has worked well for over three decades based on the very unusual price and market circumstances that occurred during a short period in 2007.

NASS. Unlike CWAP, NASS is a rather young price series, beginning in 1997. Its guidelines were developed by NASS without much, if any, input from the industry and never went through the formal rulemaking process. And consequently, they did not review comments from persons or companies directly impacted by their decision.

There are many differences between NASS and CWAP pricing. Some of these are: Types of product excluded; age of product; process used to make the product; as well as the now well-known exclusion of long-term contracts.

All of these dissimilarities will contribute to disparities in the reported prices. At the moment, the procedures used by NASS are under a formal review. As part of this process, an interim final rule has been put in place, but it is the same as the old rules. AMS states that there is good cause to not change the rules now because they have been in place for several years and to wait for comments on the interim final rule to determine if changes should be made. There is no indication that the interim final rule will, in fact, be the final rule.

The Alliance position. We are suggesting that there only be one change to the current methods for collecting and reporting nonfat dry milk sales information. Organic nonfat dry milk should not be included as reportable. Until recently, organic nonfat dry milk was not included in the CWAP report. That we believe was the obvious and correct procedure. Organic products have distinct and higher pricing mechanisms as well as higher underlying cost structures than does undifferentiated nonfat dry milk.

Organic volumes are not large, and the product is only made at a limited number of plants, but the principle is important. It is not appropriate to add value that cannot be recovered by the processors making the basic nonfat dry milk product. It isn't that organic milk costs more money to process. By that I mean to dry. But it is that it sells for much more than commodity nonfat dry milk. Even at small volumes, the much higher selling price of organic nonfat dry milk may force the other processors to pay more for their milk than they can recover from the marketplace.

I'll divert from my text for just a moment. Mr. Heffington showed me a reply he had from USDA indicating organic milk is not included in the NASS prices. We can get that verified later.

Opposed to other proposals. We are opposed to the proposal of the Western United Dairymen, the Milk Producers Council, and Dairy Institute. All of these proposals would severely limit the ability of California to participate in export trade.

Western United Dairymen has proposed that all sales based on fixed contracts are not delivered within the first 90 days of the contract signing shall not be included in the CWAP prices. The use of the 90 days is arbitrary and is difficult to justify. Is it the intent to limit all futures contracts to 90 days or less?

There are many complexities in preparing and delivering product international accounts, and we believe that the limits of this sort would curtail the potential markets to which processors could deliver product. This approach assumes that long-term contracts are always inferior to the prevailing market price and that the price received after 90 days will always be less. That supposition is not and cannot be true.

Additionally, this proposal has the unintended effect, which we think is a fatal flaw, of leaving the processor in the enviable position of being able to choose by manipulating the delivery date, whether or not a particular contract will be included in the price calculations. Our view is that all sales of the properly defined commodity products should be included in the whether sold on long-term contracts or as spot sales.

The proposal of Milk Producers Council would trade CWAP prices, which are carefully gathered weighted data from plants actually producing nonfat dry milk, for the Dairy Market News report data that is loosely gathered and is designed to assist in the orderly marketing and distribution of farm commodities. The use of this price series to set prices for producers would be devastating to operating plants and would have a chilling effect on new investment in nonfat dry milk plants.

The Dairy Market News survey is regional, voluntary, conducted by phone, not audited, includes buyers, sellers, brokers, re-sellers, and are reported as ranges, not as weighted averages. If the goal of today's process is to position California to take advantage of export markets, then you simply cannot use the Milk Producers Council proposal.

Dairy Institute's proposal to use NASS prices or to change CWAP to include the same rules is driven by their long-term objective of having the cost of milk for their products made by their members here in California stay in a steady and competitive relationship with the same products produced in surrounding states. It is a valid concern, but there are better more specific ways to address this specific issue. Additionally, their way of approaching this issue would, like the other proposals, severely hamper the ability to market California nonfat dry milk internationally.

Consequences of improper regulations. There are two readily apparent consequences of creating regulations that are out of touch with the business environment in which export transactions are made. First, potential sales to export trade will not proliferate but will instead fail to materialize and more product will have to be marketed domestically. And second, the resulting over-abundance of domestic supply will negatively impact prices.

In closing, we believe that our proposal to remove organic powder from the CWAP calculations will yield a more accurate price upon which to base the Class 4a prices. In addition, we strongly believe that long-term contracts for commodity nonfat dry milk should continue to be included in CWAP reporting.

There is before us today a chance to foster the marketing of products of California to the world. The demand for milk protein has made 2007 a very unusual year in it has presented novel circumstances, price levels, and price relationships. So far, this set of events is working out well for the state, and this industry is poised to seize that opportunity. A rush by the California dairy industry to make far-reaching changes in response to the unusual circumstances of the past twelve months could very well be detrimental to dairy producers and to nonfat dry milk processors alike.

Thank you for the opportunity to present this testimony. We respectfully request the right to submit a post-hearing brief, should you allow.

HEARING OFFICER CLEARY: Questions from the Panel?

PANEL MEMBER IKARI: As I understand, your testimony is to not put any limits on time frames in terms of long-term contracts. Recognizing both ways that long-term contracts could lead to good or bad, what would you say to the dairy farmers who indicate that they feel that there's no interest on the part of -- if we didn't provide some kind of protection, what protection is there if the processors enter into a bad deal on a long-term basis?

MR. VAN DAM: Well, that's a very interesting and far-reaching question. Underlying that concern is the thought that people are going to make stupid deals, that they're going to sell it less than they could get for it. That is simply not true. That isn't how business works. This isn't how this business works. And the nonfat dry milk plants are owned almost exclusively by producers. So these people are in the business of getting the best price they can get.

That being said, you have to recognize that occasionally there are some major surprises, and we just went through one. An unprecedented major kind of surprise where an excellent contract was put together at the time it was put together that took quite a bit of time to get delivered, and the prices just kept soaring right on past it. Those unusual circumstances was the rapid increase, and it was because of the demand for worldwide proteins. But that also drove all our prices. And it drove them hard.

And so, you know, it's referred to as a debacle that we just went through. I've done some examining of that debacle. And the debacle, if I compare June of 2006 to June of 2007, resulted in an overall increase in pool value of $293 million, one month. $293 million increase in overall pool revenue. That's a 90 percent increase.

And the CWAP price in June of 2006 was 80.27 cents I believe. I can verify that, but it's close. And the CWAP price in June of 2007, which is purported to be so terrible, was $1.47, plus change. That was an 83 percent increase in that.

So we have to understand that what happened, happened in a very dynamic environment. But the question I think is real interesting is that a contract was made and it tied up a huge amount of nonfat dry milk. May well have caused the spot markets to score higher than they would otherwise have. We just can't determine that. But that's what I'll say to them, just like I just said it to you.

PANEL MEMBER IKARI: Thank you.

PANEL MEMBER FRANCESCONI: I have a question, Mr. Van Dam. Your logic for excluding organic nonfat dry milk, if one was to take that and apply it to BST 3 nonfat dry milk, in your opinion should that be excluded, too?

MR. VAN DAM: If the product is picking up a premium on the market and causes the CWAP price to be higher than everybody in the market could get back out of it, yes, it should be excluded also.

PANEL MEMBER FRANCESCONI: Okay. That's all I have.

HEARING OFFICER CLEARY: Any other questions from the Panel?

PANEL MEMBER GOSSARD: Yes. I have a couple of questions. On page 4 of your testimony, first full paragraph towards the bottom, you say the Institute, it's a valid concern, but there are better more specific ways to address this specific issue.

Would you care to elucidate what those methods are?

MR. VAN DAM: When you consider the situation facing California right now that we have the opportunity to become marketers of nonfat dry milk to the world, you have to look at how that fact that we are marketing the stuff to the world impacts our present system. And the way it impacts our present system, it could run up or down our prices of our nonfat dry milk. And that mere fact, as Dr. Schiek points out, will cause relationship issues between the surrounding areas.

And the obvious solution there, at least one that is worth considering, is to decouple the two and deprice the Class 2 and 3 and perhaps 1 when it gets into that situation against a NASS price or the surrounding areas so that these formulas are the same. You don't have these imbalances that are such grave concern to them.

It's way beyond the scope of this hearing, however.

PANEL MEMBER GOSSARD: You said that the 90 days as proposed by Western United was arbitrary and difficult to justify. And their testimony I think clearly said they were putting this out as a strawman and were looking for insight. If not 90 days, what about six months or 18 months? Is there any time period that would be acceptable for people doing exports?

MR. VAN DAM: You know, we're not posing that you put any in there. But if you get to 18 months, we aren't going to have any objection. Contracts aren't that long.

Just understand that as a practical matter the limits that are defined in the CWAP pricing become the limits of the contracts. So it's 30 days, we don't participate in the world market. At 90 days, we miss out on a lot of contracts, because many of them go far beyond 90 days. It's very complex. You read some of the material and how difficult it is to meet all the requirements. I'm surprised they get some of them done within six months at all, which means that you can't do it. Understanding that there's a business risk in expanding beyond the period set.

PANEL MEMBER GOSSARD: My final question is a follow-up on what you said in answer to a previous question. You mentioned that the current situation was unusual to have these price discrepancies. But actually didn't we go through this about 15 years ago where a European co-op contracted with the California co-op to supply nonfat dry milk to Latin America at a fixed price, and didn't that price have impacts on the CWAP because it was there?

MR. VAN DAM: Unfortunately, Tom, I can't answer that. I believe I was in Washington state managing an association. We can look it up. I just don't know. I have not experienced it.

I was around in '89 when prices ran up for a very, very brief period and was not particularly enthralled with what happened when those prices crashed. But that was a very short lived, and it wasn't a long-term contract deal.

PANEL MEMBER GOSSARD: Okay. No further questions.

HEARING OFFICER CLEARY: Any other questions of the Panel?

PANEL MEMBER IKARI: I've an additional question. I looked at the hearing roster, and seeing that there's not a witness of DairyAmerica, I'm going to ask you a question you may or may not be able to provide.

But you indicated about the sales and how they fell in 90 days or six months. Is it possible to have you do some analysis of the sales on exports and get within those categories of 90 days, six months, 180 days where do they fall. Where do the sales fall?

MR. VAN DAM: It is probably possible. I may not be the right person to ask that question of. And a later witness, Joe Heffington, has a letter in his testimony from DairyAmerica. So it will probably be more properly addressed there.

PANEL MEMBER IKARI: Okay. Thank you.

HEARING OFFICER CLEARY: Any other questions from the Panel?

If not, I'd like to thank you for your testimony.

And for those of who are wondering, yes, why don't we take a ten-minute break. We'll recess for ten minutes and come back at five minutes until 12:00 and continue on with the public testimony. Thank you.

(Thereupon a recess was taken.)

HEARING OFFICER CLEARY: If we can get started again, we can get out of here before lunch. If I can call Joe Huntington up. The first person on our next list of people to testify would be a public list, Joe Heffington, California Dairies, Incorporated. I'd like to remind public witnesses will have 20 minutes each to provide testimony on this matter.

MR. HEFFINGTON: Good morning, sir.

HEARING OFFICER CLEARY: Good morning. State your name and spell your last name for the record and who you're affiliated with, please.

MR. HEFFINGTON: Sure. Joe Heffington, H-e-f-f-i-n-g-t-o-n. I'm Senior Vice President and Chief Financial Officer for California Dairies.

HEARING OFFICER CLEARY: Thank you.

Do you swear or affirm to tell the truth and nothing but the truth today?

MR. HEFFINGTON: I do.

HEARING OFFICER CLEARY: You may proceed.

MR. HEFFINGTON: Mr. Hearing Officer and members of the Panel, my name is Joe Heffington. I'm Senior Vice President and Chief Financial Officer of California Dairies, who I'm representing here today.

HEARING OFFICER CLEARY: Excuse me, sir. Not to interrupt, even though I did. Was it your intention to have your testimony included in the record today, the written testimony?

MR. HEFFINGTON: Yes, it is.

HEARING OFFICER CLEARY: We'll mark that Exhibit 50 for the record, and that will be entered into the record. Sorry. You can proceed.

(Thereupon the above-referenced document was marked Exhibit 50 for identification.)

MR. HEFFINGTON: Thank you.

California Dairies is a full service milk processing cooperative owned by approximately 600 dairy farmers members located throughout the state of California and collectively producing 17 billion pounds of milk per year, or 42 percent of the milk produced in California. California Dairy supplies nearly 50 percent of our milk directly to customers located in California. Additionally, our producer/owners have invested over $300 million in five large milk processing plants which produce butter, powdered milk products, cheese, and bulk processed fluid products. And before the end of this year, we'll have invested an additional $13 million in the six processing plant located in Visalia.

California Dairies currently produces over 500 million pounds of milk powders annually and is the largest producer of powdered milk products in the United States. California Dairies is a member of DairyAmerica, a federated cooperative formed for the single purpose of marketing the powdered milk products produced by DairyAmerica's member owners.

California Dairies is also a member of the Alliance of Milk Producers and supports their testimony given here today.

Our Board of Directors, which is comprised of 20 producer/owner representatives elected from our Dairy Farmer members, unanimously approved our testimony regarding CWAP reporting issues presented today at their August 27th Board meeting.

First, I'd like to point out that the reporting system under review here today has served the California industry for many years. The California weighted average price reporting instructions are broad and therefore easy to interpret and for the industry to understand. Basically, all sales of Grade A and Extra Grade nonfat dry milk are reported. And as a result, producers receive the sales value received by plants for these products, less the make allowance, and the milk checks.

We understand the frustration producers have had regarding the difference between the CWAP and NASS reported prices. California CWAP price is reflecting what California manufacturers received for the Grade A and Extra Grade nonfat dry milk made from California producers' milk. Let me repeat that. California weighted average weight is reflecting what California manufacturers received for the Grade A and Extra Grade nonfat dry milk made from California producers milk.

Significant modifications to the CWAP reporting system at this time cannot change what has happened. In fact, a change to exclude sales may have the exact reverse effect if sales prices decline. Excluding long-term fixed price contract sales may decrease the CWAP; the assumptions that all long-term fixed price contracts end up being recorded at a lower price than the prevailing market price is false.

We believe that future markets for California's growing milk supply lie to the West, with export markets, not to the East where we will compete with other milk producers who are closer to those markets and we will have to absorb an ever increasing freight cost to go east.

Export markets take time to develop and the competitive nature of these markets requires long-term price commitments. Long-term contracts are more the norm in the export markets. For example, California's largest milk powder export market, Mexico, is mostly contracted through the Mexican government agency Liconsa. Liconsa contractually requires long-term fixed price contracts for its own budgetary purposes. We've been advised that Liconsa will be requesting bids in October of 2007 for shipments during the first half of 2008 and will finalize this bidding process in November or early December 2007. This process places these fixed price contracts at a minimum of seven months in duration. Attached, Schedule A, is a letter from DairyAmerica that presents in more detail these contracting requirements with Liconsa and other export customers.

I'd like to read that letter into the record at this time, if you turn to Schedule A. This letter is from Rich Lewis. He's the Chief Executive Officer of DairyAmerica.

"The following information is in regards to the export market and the effects of changes to reporting sales to CDFA.

"DairyAmerica has been supplying member powder production to various international markets since 1995, either through brokers, direct from DairyAmerica, and over the last five years through Fonterra under our export marketing agreement.

"The international market has been serviced for years, with the majority of the powder supplied by Oceania and Europe. Over the last few years, U.S. supplies has become more competitive due to changes from cap reform in Europe, drought in Australia, changes in the value of the U.S. dollar versus other currencies, as well as export bans put on the governments from Argentina and India.

"International contracting has, for years, been done on a medium term to long term fixed price basis, six to twelve months. This is mainly done because customers want to lock up their costs, know they have a secured supply, and some customers, being government agencies, need to secure financing from their government. There are short term contracts, two to three month duration, but these are the exceptions, not the rule.

"DairyAmerica's largest market is Mexico. One of the largest buyers in Mexico is Liconsa."

And just for informational purposes, their contract that's coming up is about 60 million pounds a year. Not inconsequential.

"This agency commits to purchases based on a minimum of six months contracting. For instance, we will begin negotiations to supply Liconsa in mid October 2007 for shipments January to June 2008. Liconsa will be making their decision to commit to a supplier by late November to the first of December 2007 for that contract. In addition, we will see the same conditions for a number of large multi-national companies looking to lock up supply and price from the first quarter to the first half of 2008. Those producers providing the requirements of a fixed price and supply for customer contracts will be the preferred providers and will receive a contract.

"Mexico is not the only country that purchases through government agencies. We also have supplied in the past Algeria and Cuba through their government agency purchasing departments. I've become aware that Algeria represents about 20 million pounds and Cuba about 13. These contract opportunities would also be subject to any changes being reviewed by the Department on Tuesday, August 28th, 2007.

Algeria will be looking to bid their supply for the first quarter of 2008 in September 2007. They will be followed by Cuba in late September/early October for their first quarter 2008 requirements. Both of these markets have been supplied at one time or another by DairyAmerica members from California.

"As mentioned above, multi-national customers also require fixed price contracts on a six to nine month basis for their supply needs and will look to others to supply, if DairyAmerica cannot meet the terms they require.

"Summary: International dairy markets work differently from U.S. markets. International markets use long-term fixed price contracts versus weekly pricing for U.S. markets."

I'm going to read that sentence again.

"International dairy markets work differently from U.S. markets. International markets use long-term fixed price contracts versus weekly pricing for U.S. markets. DairyAmerica, and its members, have invested huge sums of time and money to develop both domestic and international customer relations. To have something other than market conditions affect those relationships would be a major step backwards and will have detrimental effects to the contribution powder provides to producer milk prices."

At this point, I'd like to move on to the very next page, which is Schedule B. And this is a schedule prepared by USDA that shows the top ten exporting states exporting dairy products and their dollar value of exports for the last ten years. And you can see California by far leads the way in exports of dairy products. For 2006, that was $390 million. For 2007, you can expect that number to increase substantially with the dollar value increase that we've had and at the volumes we're exporting.

Just so you have an idea of what the magnitude of pounds of powder that's exported, DairyAmerica in 2006 exported over 400 million pounds of milk powders. A good share of that was from California.

Back to my testimony. We believe California regulations should not restrict California's ability to serve these important export markets, but rather should encourage development of these markets. Adopting rules that exclude sales from the reported price would place tremendous price risk on the contracting manufacturer. Manufacturers would be more reluctant to commit to the export volumes that will be necessary to balance the growing milk production in California. This in turn would back up tremendous volumes of product on the domestic market, and it should be clear that this would have the effect of lowering domestic prices.

Regulations should be flexible enough to allow California nonfat dry milk processors to engage in business transactions that will enhance California's position as a reliable major exporter of nonfat dry milk. We believe that the current reporting rules for California do just that.

The California weighted average price reporting rules were reviewed at industry meetings during the 1990's, and results of these meetings centered around the timeliness and accuracy of the weekly and monthly reports and improving the Department's audit procedures to insure the accuracy of the data. As a result of those meetings and after many hours of industry input, reporting procedures and audit procedures were set in place by the Department to assure the accuracy of the reports. There truly is not another system like this in the entire U.S.

The interim rule offered by NASS contains a more complex set of reporting rules. Also, the concept of auditing submitted reports is foreign to NASS. Even after NASS announces its Final Rules, they'll have a lot of work to do. NASS must develop auditing procedures and administrative interpretations that will be necessary as a result of the more complex rules that may be adopted. It is fair to say they're behind on those efforts and that should have been completed long ago and now they are playing catch up.

Modification to California's system to match or incorporate portions of a system currently under pressure to adopt rules and institute procedures just does not make good sense. We also disagree with the thought that alignment with NASS reporting is necessary in California producers' long-term best interest. The California dairy industry needs to do what is right for California.

In summary, export markets are very encouraging and have great potential for the future if we maintain our commitments. Regulations that support and encourage development of these markets is what is needed.

California's current reporting procedures do just that. Thank you for your attention to my testimony today.

PANEL MEMBER GOSSARD: On the attached letter from DairyAmerica on the first page, it mentions most contracts there's six to twelve months on a fixed basis. Is twelve months the maximum? Have there ever been any contracts, fixed price, have run more than twelve months?

MR. HEFFINGTON: Ever is a very long time. Being that I'm not in the marketing industry, marketing our powdered milk, I don't have an answer to that. I can only go by the letter that they've given me on that.

PANEL MEMBER GOSSARD: Well, then my follow-up question is if we modify the Western United proposal, instead of 90 days to make it twelve months, would that incur any problems for the export market of nonfat dry milk?

MR. HEFFINGTON: Based on the information provided in this letter, I don't believe twelve months is a tremendous problem.

PANEL MEMBER GOSSARD: Also on that page it mentioned that DairyAmerica has an export marketing agreement with Fonterra, but it also says DairyAmerica directly sells export powder to Mexico, Cuba -- well, potentially to Mexico, Cuba, Algeria. How does that marketing agreement with Fonterra work? Who do they export to for DairyAmerica? Is there some regional --

MR. HEFFINGTON: Fonterra and DairyAmerica's marketing agreement has existed for five years now. And it's a good marriage of a good business relationship between the two companies, because Fonterra has sales offices all over the world. I don't believe there's any restrictions on where Fonterra would market or DairyAmerica would market worldwide.

PANEL MEMBER GOSSARD: And finally on top of page 2 of your testimony, you say that CDI is a member owner of DairyAmerica. As an owner, does that mean that CDI participates in any profits or loss that DairyAmerica may incur?

MR. HEFFINGTON: Yes. That's true. It's a cooperative. Just like California Dairies is a cooperative. And the members share in the profits of the company depending on the formulas. There's certainly different accounting formulas for profits -- profit sharing within cooperatives.

PANEL MEMBER GOSSARD: To the best of your knowledge, has California Dairies benefited by profits from DairyAmerica or more often had losses from their owning DairyAmerica?

MR. HEFFINGTON: We have profits from DairyAmerica. It has been a profitable business, yes.

PANEL MEMBER GOSSARD: No further questions.

PANEL MEMBER IKARI: I just want to -- and I understand confidentiality. I'm not asking that you answer or say anything that's confidential. But to the extent possible if you can provide summary information that would summarize the export sales in terms of length of months, if it's twelve months, eighteen months, six months or 90 days that would be helpful for us.

MR. HEFFINGTON: I heard your question earlier, and DairyAmerica staff will work on it.

PANEL MEMBER IKARI: Thank you.

HEARING OFFICER CLEARY: Any further questions of the Panel at this time?

I'd like to rule on allowing a post-hearing brief period. I know everybody has been curious about it. Everybody is interested in one, so I'm here to please. The response is granted for all witnesses who have requested a post-hearing briefing period. The opportunity to submit a brief amplifying, explaining, or withdrawing their testimony is granted.

In order for the brief to be considered, the Department must receive the brief by Tuesday, September 4th, 2007, by 4:00 p.m. The brief may sent or submitted to the Department's branch office located at 560 J Street, Suite 150, Sacramento, California, 95814. The brief may be faxed to area code (916)341-6697 or sent by e-mail to Dairy@cdfa.ca.gov.

I thank you for your testimony, sir.

I'd like to call the next witness, Thomas -- and I apologize. Is it Wegner?

MR. WEGNER: It is Wegner.

HEARING OFFICER CLEARY: Will you be testifying as well?

MR. GRUEBELE: I'll be testifying for response.

HEARING OFFICER CLEARY: In that case, I'll swear you both in. Could I have each one of you state your name, spell your last name for the record, and who you're representing today?

MR. WEGNER: I'm Tom Wegner, W-e-g-n-e-r, testifying on behalf of Land O'Lakes.

MR. GRUEBELE: I'm Jim Gruebele, G-r-u-e-b-e-l-e, here to respond only.

HEARING OFFICER CLEARY: And do you both swear or affirm to tell the truth and nothing but the truth today?

MR. WEGNER: Yes.

MR. GRUEBELE: Yes.

HEARING OFFICER CLEARY: Thank you very much. You may begin your testimony.

MR. WEGNER: Mr. Hearing Officer and members of the Panel, my name is Tom Wegner. I'm here to testify on behalf of Land O'Lakes. My business address is 4001 Lexington Avenue North, Arden Hills, Minnesota. My current title is Director of Economics and Dairy Policy.

We thank the Department for promptly calling this hearing to address these issues of critical importance to all of our dairy producer members. Land O'Lakes is a dairy cooperative with 3,100 dairy farmer member owners. The cooperative has a national membership base whose members are pooled on a California state program and six different federal orders. Land O'Lakes members own and operate several cheese, butter-powder, and value-added plants in the upper Midwest, East, and California. Currently, our 275 California member owners supply us with over 16 million pounds of milk per day that are processed at our Tulare and Orland plants.

When considering amendments to the weekly and monthly nonfat dry milk sales reports, we strongly recommend that the CDFA Department consider the importance of exports to the future growth of the nonfat dry milk market and the result of impact of that growth on producer prices in California.

Secondly, we want to highlight for the Department how the terms of sale differ when entering into an export contract as compared to a domestic contract.

Thirdly, we recommend that the Department stay in close contact with the USDA agricultural marketing service regarding the proposed interim final rules that directly relate to the collection of nonfat dry milk values and their use in the federal milk marketing order system's classified pricing formulas.

California's producers have a huge stake in nonfat dry milk production. As you know, California plants have annually manufactured nearly one half of all the nonfat dry milk produced in the U.S. In the first half of 2007, California's plants have manufactured roughly 367 million pounds of nonfat dry milk, accounting for around 54 percent of the total nonfat dry milk produced in the U.S. California's nonfat dry milk production peeked at slightly less than 750 million pounds in 2004 according to the CDFA and the USDA dairy products report.

Recall that cooperatively-owned plants make the vast majority of California's nonfat dry milk. More specifically, LOL, California Dairies, and Dairy Farmers of America's cooperative dairy members own and operate seven plants that make nonfat dry milk in California.

Exports are a key component in the future of the nonfat dry milk market. According to the U.S. Dairy Export Council, 42 percent of the nonfat dry milk produced by U.S. plants in 2006 got exported. 42 percent translates roughly into 520 million pounds of nonfat dry milk. On a milk equivalent solids basis, 520 million pounds equates to roughly 3.6 billion pounds of milk, representing nearly 75 percent of the 4.8 billion pounds of milk added to the U.S. supply in 2006.

Clearly, if nonfat dry milk exports had not been as robust, the U.S. nonfat dry milk market would have been much weaker with the clear potential for sales going to commodity credit corporation. Alternatively, this additional milk could have ended up as cheese and whey, which could have further depressed those markets in 2006. Instead, by early 2007, all dairy product markets have been enhanced by the export driven strength of the nonfat dry milk markets.

Land O'Lakes, CDI, and DFA market their nonfat dry milk through DairyAmerica, a federated marketing cooperative association organized in 1995 for the purpose of jointly marketing dairy products like nonfat dry milk. Participating in DairyAmerica allows Land O'Lakes dairy producers to benefit from collectively marketing our nonfat dry milk instead of competing against other farmer-owned manufacturers of nonfat dry milk for powder sales. The cooperatives of LOL, CDI, and DFA supply the vast majority of nonfat dry milk that DairyAmerica markets.

DairyAmerica's nonfat dry milk export sales display how important international customers have become to the nonfat dry milk market. DairyAmerica's export sales of nonfat dry milk represented over 75 percent of the total nonfat dry milk exports in 2005. More specifically, in 2005, DairyAmerica exported 407 million pounds of nonfat dry milk. In 2006, DairyAmerica exported 406 million pounds. Through June 2007, DairyAmerica has exported 173 million pounds. These volumes represented 38 percent of the 2005 sales, 36 percent of the 2006 sales, and 33 percent of year-to-date June sales. Clearly, international sales have become a critical component of the nonfat dry milk market.

The importance of export sales to California's dairy industry has also grown. A recently released report from the USDA's economic research service reveals that California's dairy exports accounted for nearly 20 percent of the $1.8 billion worth of U.S. dairy exports in 2006. More specifically, California's dairy exports have grown in value by nearly $170 million, representing an increase of over 80 percent from 2002 to 2006.

Land O'Lakes strongly urges the Department to consider the important role the exports have played in the market strength observed in nonfat dry milk prices over the past two years. Aggressive exporting of nonfat dry milk has tightened up the domestic market for milk proteins leading to higher prices. Accordingly, the record high nonfat dry milk prices have translated directly into higher classified prices. In this way, rising nonfat dry milk prices driven by international demand have directly benefited California's milk producers.

Export terms of sale differ from domestic terms of sale. The terms of export sales differ from the terms of spot sales. DairyAmerica tells us that international trading has a long tradition of fixed price contracts. The shortest term contracts typically cover small volumes of two million pounds and usually take 30 to 60 days to complete. The longest term contract may take as many as 180 to 360 days to complete and could cover sales volumes of up to 40 million pounds. Export sales are usually made from commitments of future production and are rarely made from inventory stocks. It seems clear that coordinating, assembling, and preparing these volumes for export could easily require more than 30 days.

One of the key differences between selling nonfat dry milk to domestic customers as compared to selling nonfat dry milk to international customers centers on the length of the documentation process. This process includes securing a certificate of free sale, ocean bills of lading, USDA sanitary and health certificates, and letters of credit. Securing these and other requirements to export dairy products may take 30 or more days after the date of the agreement on a fixed price contract. It is our understanding that these documentation requirements must be met before shipping any product and invoicing for it. We understand that the vast majority of nonfat dry milk export sales in recent years go through this time-consuming documentation process and by necessity contain fixed price provisions that extend well beyond 30 days.

Limiting the inclusion of fixed price contracts to those executed in 30 days or less would negatively impact export of nonfat dry milk in two ways. First, since there is no 4a futures market and the Chicago Mercantile Exchange's nonfat dry milk market has very little activity, suppliers have limited opportunities to hedge against the risk of spot prices for nonfat dry milk moving against them. Thus, suppliers would likely choose to enter into far fewer fixed price contracts of more than 30 days. Secondly, nonfat dry milk customers would need to change their way of doing business by either accepting shorter-term fixed price contracts or designing contracts that share in the price risk with suppliers. The lack of a 4a futures market also limits nonfat dry milk customers' ability to hedge sales or purchase contracts for future delivery.

The Department also needs to consider the impact of any amendments on existing contracts that were entered into under current reporting rules. Consideration should be given to allowing sufficient lead time to participate in longer-term fixed price contracts to fully satisfy them before implementing new rules.

Let me read that one more time. Consideration should be given to allowing sufficient lead time to participants in longer-term fixed price contracts to fully satisfy them before implementing new rules.

Closely monitor the USDA's progress on establishing a dairy product mandatory reporting program. By way of background, the USDA ag marketing service has issued an interim final rule establishing a dairy product mandatory reporting program. This interim rule will implement a plan to verify the price information submitted to the National Agricultural Statistic Service. The AMS will audit the sales and price information submitted by dairy product manufacturing plants to NASS to ensure that eligible sales transactions agree with information submitted to NASS and will check for eligible sales transactions that were not reported to NASS.

Considering our eastern and upper Midwestern membership and manufacturing plants, Land O'Lakes also has a stake in the USDA's NASS dairy products price series for nonfat dry milk. We feel the USDA needs to use prices that best reflect the full value of NASS nonfat dry milk sales in the market. We would prefer that the USDA would make no distinction between spot sales, domestic sales, or export sales to best ensure that the price surveys capture the entire population of nonfat dry milk sales. In this way, we will urge the USDA to expand their price survey to include fixed price sales for export of the four commodity dairy products with terms up through 90 days.

We urge the Department to stay in close contact with the USDA administrative process to better align the NASS and CWAP prices to eliminate the potential for any regional advantages or disadvantages. Clearly, it is in the best interest of the dairy industry to reach an agreement on how to price nonfat dry milk fairly in both the California and Federal Order systems.

We are concerned that limiting the export sales to 90 days or less could inhibit the ability of suppliers to export important quantities of powder. For example, we have learned that the shortest term contracts typically cover small volumes of two million pounds and usually take from 30 to 60 days to complete. But the longer-term contracts may take as many as 280 to 360 days to complete and cover sales volumes of up to 40 million pounds.

Including exports beyond 90 days could indeed be beneficial to dairy producers in a down cycle in powder markets. Most market analysts foresee that the next big turn in the nonfat dry milk market is probably downward. This may not occur right away. However, when the turn comes, it is probably going to be a downward shift. The CWAP price, without a time restriction, would more than likely decline much slower than would be the case if the contracts were limited to a period of 90 days. On the other hand, when powder markets are in an up cycle, the CWAP price without a time restriction would tend to increase at a slower rate than if contracts were limited to a 90-day term.

Despite our concerns about the potential negative impact on export sales of excluding fixed price contracts beyond 90 days, we support the proposal of the Western United Dairymen. Specifically, we support the inclusion of contract sales of nonfat dry milk that are delivered within 90 days of contract execution in the weekly and monthly CWAP prices.

We agree with the Alliance of Western Milk Producers that the CWAP should exclude nonfat dry milk made from organic milk and the powders from organic milk should be removed from the list of eligible products. Organic milk products have costs and pricing arrangements that differ significantly from the costs and pricing arrangements of commodity style products.

We do not support the proposal to replace CWAP with the simple average of the nonfat dry milk west mostly prices as published about USDA's Dairy Market News. We remind the Department that these prices have no volume accompanying them, thereby running the risk that these prices could end up reflecting a very small volume of product sales. Without any auditing of the sales, we have no assurance that the prices are reported accurately. We have concerns that the price series may reflect spot transactions, but may not capture a significant volume of the nonfat dry milk sold under fixed price terms.

In addition, the use of the spot markets have even more serious disadvantages than the current NASS rules that limit contracts to a 30-day period. The use of the spot market would severely discourage suppliers from entering into any kind of export contract. The risks associated with entering into an export contract would simply be too large.

Nonfat dry milk prices have been and will continue to be favorably impacted by exports. The exclusion of nonfat dry milk export sales will result in a price that does not reflect the real value of the nonfat dry milk market. The long-term interest of producers would be best served with the use of the current rules of CWAP. However, Land O'Lakes does, in fact, support the Western United position of limiting contracts for a 90-day period.

Accordingly, we do not support the Dairy Institute's proposal to include only fixed price contacts with terms of 30 days or less for the reasons we stated earlier concerning the length of time required to secure the documentation necessary to execute an export contract.

Conclusion and summary. The ongoing market events of 2007 have again confirmed how small changes in the balance between milk supply and demand can have huge impacts on price. Although it is difficult to estimate how much the export of nonfat dry milk has contributed to the strength of the dairy product markets, there is no denying it has played an important role in the near record high prices of 2007.

The Department needs to consider very carefully how any changes in the CWAP would impact the opportunity for California's dairy producers to continue to effectively serve the future needs of the global marketplace and thereby share in the benefits.

It would be inadvisable for CDFA to rule on any changes until a final rule has been established by the USDA that relates to the collection of nonfat dry milk values and their use in the federal milk marketing order system's classified pricing formulas.

If the USDA's final rules with respect to the collection of nonfat dry milk values remain unchanged from the current 30-day limitation of contract sales, Land O'Lakes then would continue to support the inclusion of contract sales of nonfat dry milk that are delivered within 90 days of contract execution in the weekly and monthly CWAP prices. The 30-day time limit in our opinion is simply too restrictive, and that policy will likely harm the long-term returns for dairymen.

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

HEARING OFFICER CLEARY: That request is granted, and you will have the same time frame as the other witnesses, September 4th by the 4:00 p.m.

Would you like to have your written testimony entered into the record?

MR. WEGNER: Yes, sir.

HEARING OFFICER CLEARY: That testimony will be entered in as Exhibit 51 for the Department.

(Thereupon the above-referenced document was marked Exhibit 51 for identification.)

HEARING OFFICER CLEARY: Any questions of the Panel?

PANEL MEMBER GOSSARD: I have one question. At the top of page 3, you say participating in DairyAmerica allows LOL's dairy producers to benefit from collective marketing instead of competing against other farmer-owned manufacturers.

But wouldn't it make more competitive market if there was competition?

MR. WEGNER: I guess the point I'm making there is the collective bargaining may be able to advance the price as opposed to each going after the same customers.

PANEL MEMBER GOSSARD: No further questions. Thank you.

HEARING OFFICER CLEARY: Anyone else on the Panel?

Thank you very much for your testimony, gentlemen. You're excused.

The next witness on the list is Patricia Stroup. Good morning. Could I get you to please state your name, spell your last name for the record, and let us know who you're affiliated with.

MS. STROUP: Patricia Stroup, S-t-r-o-u-p, representing Nestlé USA and Dreyer's Grand Ice Cream.

HEARING OFFICER CLEARY: Was it your intention today to have your written statement included as an exhibit into the record?

MS. STROUP: It is.

HEARING OFFICER CLEARY: I notice that because you even have a space for exhibit on your form.

So it will be Exhibit Number 52 entered into the record at this time.

(Thereupon the above-referenced document was marked Exhibit 52 for identification.)

HEARING OFFICER CLEARY: And do you swear or affirm to tell the truth and nothing but the truth today, ma'am?

MS. STROUP: I do.

HEARING OFFICER CLEARY: Proceed.

MS. STROUP: My name is Patricia Stroup. I'm the Group Manager for Dairy for Nestlé Business Services, NBS. And today I am representing Nestlé USA and Dreyer's Grand Ice Cream. In my roll as NBS, I am responsible for milk and dairy ingredients procurement for Dreyers and Nestl brand in the United States and Canada. This includes procurement relationships with individual dairy farms, cooperatives, and priority handlers and manufacturers. I developed today's testimony in cooperation with Nestlé and Dreyers staff and present it today with authorization from Nestlé and Dreyer's Grand Ice Cream executive staff.

I have some data there on the background of Nestlé and Dreyer's, which you can read at your leisure.

Nestlé and Dreyer's primary California operations include its Nestle evaporated milk plant, two Dreyer's and Haagen-Dazs ice cream plants, and a prepared food factory, along with distribution centers and business offices.

I testify today in support of the Dairy Institute of California's alternative proposal to change the specifications for product to be included in the weekly and monthly nonfat dry milk sales reports, which form the basis for the California weighted average price currently used in the stabilization and marketing plans for calculation of Class 1 and Class 4a and by association Class 3 milk prices.

I'd like to express my appreciation of CDFA's thought-filled discussion around this issue. I know it is one that does not have an easy answer, and we have not wanted to solve a long-term problem with a short-term solution. However, we as a manufacturer and a major user of nonfat dry milk priced product have put considerable thought into what solutions is best for industry at large and most likely to promote sustainability of California production.

The primary focus of my comments is to the treatment of long-term contracts for price reporting purposes. The Dairy Institute proposes to exclude from the survey sales in which the selling price was set, not adjusted, 30 or more days before the transaction was completed. We are supportive of this methodology for the following reasons.

First of all, a relatively short period such as 30 days permits supply and demand signals to be transmitted efficiently and rapidly. Price series adjust more quickly, and therefore supply and demand can also adjust smoothly in response to these price signals. For example, in times of extremely short supply, the function of prices is to ration demand. This demand rationing function cannot operate if prices are slow to reflect current conditions. This disconnect between supply and demand was illustrated painfully earlier this year when long-term contracts were mistakenly included in the NASS price survey. High nonfat dry milk prices were not communicated back to dairy farmers through the survey price, so supply was slow to respond to economic necessity.

The 30-day time period is consistent with the important goal of price transparency. Ultimately, prices are means of conveying information about the value of a product. The inclusion of long-term contracts where delivery prices reflect supply and demand conditions during past periods would markedly reduce price transparency. Indeed, the recent controversy over nonfat dry milk prices is an example of just such a lack of transparency. Market participants will find it difficult to interpret prices if the time period they represent cannot be known. The market will be unable to discern whether prices are reflecting of current or past marketing conditions.

Use of a 30-day period allows consistency within CDFA price formulas. Currently, CDFA cheese and CME butter used in 4a and 4b formulas represent a current market price. It is logical for nonfat dry milk prices to be established in a parallel fashion. In fact, Section 61802 of the California Food and Agricultural Code instructs that pricing standards governing minimum producer prices for market milk conform to current economic conditions.

Finally, use of a 30-day period is consistent with the USDA's interim final rule. An important aspect of the two petitioners' proposals is to achieve closer alignment with federal pricing methodology in order to maintain a reasonable and sound relationship with the national value of manufactured milk products. The Dairy Institute's alternative proposal mirrors the language included in the methodology outlined by USDA's Agricultural Marketing Service for Dairy Product Mandatory Reporting Program published in July. These specifications used by the NASS became effective August 2nd. Adoption of the Dairy Institute's proposed methodology would bring the California's weighted average price for nonfat dry milk into a reasonable and sound relationship with federal prices reported by NASS.

Our view that regulated prices should reflect current, not past, market conditions underlies our support for Dairy Institute's alternative proposal. However, should CDFA decide to use a period longer than 30 days, we feel there would be an obligation to compensate for the resulting lack of transparency by taking other steps to supply information to the marketplace. In particular, CDFA would in our view have responsibility to provide more information about the volume of sales under such long-term contracts.

In addition, CDFA should provide information about product volumes delivered under prices set in various intervals. For example, sales volumes where the price was set less than 30 days ago, between 30 and 60 days, between 60 and 90, et cetera, and more than 90 days ago.

Finally, the Department should include information on average expiration dates for long-term contracts that enter into reported prices.

We are aware that such reporting could cause some difficulties involving the identification of individual firms and proprietary information. But we would point out all such difficulties would be avoided by simply not including longer time periods. We would strongly object to any price reporting regime that left the marketplace in the dark about whether price series were reflecting current market conditions or the supply-demand fundamentals of an earlier period.

My final comment is to oppose the use of price information reported in Dairy Market News or any other news publication in regulated pricing formulas. The methodology used to collect information for these publications relies on personal discussions between manufacturers and reporters. While this is fine for reporting news and opinions as perceived by manufacturers for general industry bedtime reading, it is not a credible methodology for setting mandatory regulated prices. The information gathered and reported is not verifiable. It is not weighted. And it is highly susceptible to qualitative characteristics of the personal interview.

I thank you for the opportunity to express the views of Nestlé and Dreyers on this matter today. I would respectfully request the opportunity to submit a post-hear brief and would be happy to address any questions you may have.

HEARING OFFICER CLEARY: Your request for the brief is granted, and you'll have the same time frame as the rest of the witnesses, September 4th by 4:00 p.m.

Any questions from the Panel?

PANEL MEMBER GOSSARD: I just have one on page 2 of your testimony second paragraph -- first paragraph. You're talking about the companies Dreyer's owns in California. In terms of volume of milk, is Dreyer's

Nestle's primarily Class 3 operation with little of the others? Or what sort of mix do you have, relatively speaking?

MS. STROUP: We are probably half and half. We have the 4a facility in Modesto as well.

PANEL MEMBER GOSSARD: Thank you. No further questions.

HEARING OFFICER CLEARY: Any other questions of the Panel? Hearing none --

MS. STROUP: Can I add one statement? I do notice there has been a lot of discussion about export potential. And we are probably the largest purchaser of nonfat dry milk in the world. This also concerns us. We would like to be able to continue to purchase product from the United States and from California.

One of the things that has not come up in the discussion -- and this was definitely something that we considered greatly as we pondered what our priorities were on our position at this hearing. Skim milk powder is the world currency for dried milk proteins. And when we tender, it is the product that we are asking to buy.

The decision by producers or manufacturers to sell nonfat dry milk instead of skim milk powder in our experience has been something that we leave to the manufacturer and not something that we specifically request.

If the manufacturers did supply skim milk powder, in which case they do often do that, that product is not included in the CWAP in any case. So for that major reason, we don't feel that the exclusion of long-term contracts for nonfat dry milk is a hindrance to the marketing of milk proteins from California.

The other comment is risk management, which has also been one of our concerns. We do know because we are working with the CME that they will be moving the nonfat dry milk contract onto the Globex platform, and there will be a market maker that will be involved in developing that market. So we're feeling much more comfortable about the ability to forward contract to hedge our purchases.

And, finally, we feel uncomfortable that the effort to have all dairymen in California provide the hedge mechanism for a product rather than those that own and market the product by involving the regulated system as the hedge mechanism is probably not a long-term sustainable mechanism to develop the California dairy export market.

HEARING OFFICER CLEARY: Does the Panel have any comment or question on the additional comments?

Is that all?

MS. STROUP: That's it.

HEARING OFFICER CLEARY: I thank you very much for your testimony, and you're dismissed at this point.

Just as a practical housekeeping, again I know I spoke of breaking for lunch at 12:30. However, we only have two other folks signed up to testify. So if it's just the same to everybody else, I'd like to plow through this and finish up before and get out of here.

If Scott Magneson can please come up. Good afternoon, sir.

MR. MAGNESON: Good afternoon.

HEARING OFFICER CLEARY: If I could have you state your name, spell your last name, and let us know who you're representing today, please.

MR. MAGNESON: My name is Scott Magneson, M-a-g-n-e-s-o-n. And I'm representing the California Dairy Campaign.

HEARING OFFICER CLEARY: Was it your intention to have the written testimony included in the record as an exhibit today?

MR. MAGNESON: Yes, it is.

HEARING OFFICER CLEARY: It will be marked Exhibit Number 53 for the Department.

(Thereupon the above-referenced document was marked Exhibit 53 for identification.)

HEARING OFFICER CLEARY: Sir, do you swear or affirm to tell the truth and nothing but the truth today?

MR. MAGNESON: Yes, I do.

HEARING OFFICER CLEARY: Then you may proceed.

MR. MAGNESON: Mr. Hearing Officer and members of the Panel, my name is Scott Magneson. I operate our family dairy farm in Ballico. I currently serve on the Board of Directors of the California Dairy Campaign and testify today on behalf of the dairy producer members we represent throughout the state. The testimony I'm presenting today is based on positions adopted by the CDC Board of Directors at our most recent Board meeting.

California Dairy Campaign is testifying in support of the petition put forward by the Milk Producers Council which calls for the California Department of Food and Agriculture to make changes to the methods used to determine the market value of nonfat dry milk in the Class 4a pricing formula and in the commodity reference price.

At the beginning of this year, the nonfat dry milk price included in California's 4a formula has been significantly below all other price indicators, the CME cash market, the NASS, and the Oceania price. Because the California weekly average price used in the 4a and commodity reference price does not reflect the national value of nonfat dry milk used in surrounding federal orders, California's class prices will not be able to maintain a reasonable and sound relationship with the national value of manufactured milk product as called for in the California Food and Agricultural Code.

We call upon CDFA to immediately change its pricing formulas to use the value of nonfat dry milk based upon the simple average of the nonfat dry milk west mostly prices published in the Dairy Market News.

In our testimony, we have included a chart that illustrates the difference between the CME cash price and the California weighted average price. The chart shows when the CME cash price moved higher, it took a year for the California weighted average price to reach the higher cash market price. However, when the CME cash price decreased, the CWAP dropped immediately. We believe the chart dispels the notion that long-term contracts work both ways by keeping price higher longer on a down market.

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

We would like to request the opportunity to submit a post-hearing brief.

HEARING OFFICER CLEARY: Your request is granted. You'll have the same time frame as all the other witnesses, September 4th at 4:00, by the same vehicles and methods described earlier.

Does the Panel have any questions of the witness?

Then I thank you very much for your testimony.

I'd like to call the Department's representative, Mr. Doegey, back to the chair.

Mr. Doegey, do you have additional testimony you'd like to proceed with today?

SENIOR AGRICULTURAL ECONOMIST DOEGEY: There was a series of five questions that were asked by Mr. Kaczor --

HEARING OFFICER CLEARY: My question was, did you want to proceed with additional testimony today?

SENIOR AGRICULTURAL ECONOMIST DOEGEY: Yes.

HEARING OFFICER CLEARY: I will remind --

SENIOR AGRICULTURAL ECONOMIST DOEGEY: Was my first response not the answer to your question?

HEARING OFFICER CLEARY: I'll remind you you're still under oath and you can proceed.

SENIOR AGRICULTURAL ECONOMIST DOEGEY: Great.

Mr. Kaczor did ask us five questions. And in order to properly give adequate response to a few of those, we've decided what we would do is provide a response to those five questions in our post-hearing brief.

HEARING OFFICER CLEARY: Thank you.

Does anyone have any questions of the Department's witness reference that statement? Yes, sir.

MR. KACZOR: I'm John Kaczor.

Does that mean that the post-hearing brief that would be provided in answer to the questions would not be in time for us to incorporate the answers and evaluate those answers within the time frame given to us, in which case it would be a non-answer?

PANEL MEMBER IKARI: The Department will try to respond as quickly as we can. Hopefully within a day or two.

MR. KACZOR: I appreciate that.

PANEL MEMBER IKARI: So there will be plenty of time for you to consider what the post-hearing brief says and incorporate it in your brief.

HEARING OFFICER CLEARY: Did you have a comment?

MR. MARSH: Mike Marsh, Western United Dairymen. Perhaps I misunderstood as well. Would this response be in the post-brief or not? It would be in a separate document prior to the time of the filing of the post-hearing brief so Mr. Kaczor could utilize that?

HEARING OFFICER CLEARY: Yes. My understanding is that the -- from the conversation with the Panel members that they intend to post it on their website for everyone to have available.

PANEL MEMBER IKARI: Mr. Doegey, doesn't the Department intend to post it on their website and provide the information to the stakeholders that participated in the hearing?

SENIOR AGRICULTURAL ECONOMIST DOEGEY: Yes. I think our intention is to provide that within a few days so you have ample time to review it before your post-hearing briefs would be due.

HEARING OFFICER CLEARY: Do you have any further?

SENIOR AGRICULTURAL ECONOMIST DOEGEY: I think I do not.

HEARING OFFICER CLEARY: Thank you. You are dismissed.

At this time, the last item we have to attend is we still do -- Ms. LaMendola, you have 25 minutes remaining on your time. Did you intend to use that today?

MR. LA MENDOLA: No, thank you.

HEARING OFFICER CLEARY: Well, then, this is my favorite part of doing one of these things. No other business coming before this hearing, I hereby declare the meetings closed. And I thank you all very much for your cooperation and the professionalism and the way in which you conducted yourselves today. Thank you.

(Thereupon the Department of Food and Agriculture Market Milk Hearing adjourned at 12:54 p.m.)

CERTIFICATE OF REPORTER

I, TIFFANY C. KRAFT, a Certified Shorthand Reporter of the State of California, and Registered Professional Reporter, do hereby certify:

That I am a disinterested person herein; that the foregoing hearing was reported in shorthand by me, Tiffany C. Kraft, a Certified Shorthand Reporter of the State of California, and thereafter transcribed into typewriting.

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

IN WITNESS WHEREOF, I have hereunto set my hand this 4th day of September, 2007.

TIFFANY C. KRAFT, CSR, RPR
Certified Shorthand Reporter
License No. 12277