Hearing Panel Report

Based on a Public Hearing Held
October 10 and 11, 2007

Addressing Pricing Formulas for Classes 4a and 4b
Contained In the
Stabilization and Marketing Plans
For Market Milk for the
Northern and Southern California Marketing Areas

and

Amendments to the Pooling Plan for Market Milk

Hearing Panel Report

Addressing Pricing Formulas
For Classes 4a and 4b and the Pool Plan
Based Upon a Public Hearing Held on October 10 and 11, 2007

This Report of the Hearing Panel regarding proposed amendments to the Stabilization and Marketing Plans for Northern California and Southern California (Stab Plans) and the Pooling Plan (Pool Plan) for Market Milk is based on evidence received into the Department of Food and Agriculture hearing folder. The folder includes the Departmental exhibits, written statements and comments received from interested parties, written and oral testimony received at a public hearing held Wednesday, October 10 and Thursday, October 11, 2007, and written post-hearing briefs.

The Department received a petition from F&A Dairy of California, Inc. and a group of other California cheese processors, requesting a public hearing to consider amendments to the Stab Plans. After receipt of a second petition from the Alliance of Western Milk Producers, Milk Producers Council, and Western United Dairymen requesting changes to the Stab Plans and the Pool Plan, the Secretary expanded the call of the hearing to include amendments to the Pool Plan.

Table of Contents

Introduction, Summary of Proposals, and List of Witnesses ..... Page 3

Background: California's Dairy Landscape ..... Page 5

Analysis and Discussion

- Plant Credits and Multi-Tier Pricing ..... Page 7
- f.o.b. California Price Adjusters ..... Page 17
- Whey Factor in the Class 4b Pricing Formula ..... Page 21
- Manufacturing Cost Allowances ..... Page 30

Appendix A: Summary of Proposals ..... Page 41

Appendix B: Department Memorandum, December 1982 ..... Page 42

Appendix C: Summary of Testimony and Post-Hearing Briefs ..... Page 48

INTRODUCTION, SUMMARY OF PROPOSALS AND LIST OF WITNESSES

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

The Gonsalves Milk Pooling Act, California Food and Agricultural Code Section 62700, *et sec*., authorizes the Secretary to operate a statewide pooling system under specified guidelines. These statutes provide for the formulation and adoption of Milk Pooling Plans for Market Milk (Pool Plan).

Petitions were submitted by:

1. F&A Dairy of California; Marquez Brothers International; Farmdale Creamery; Rumiano Cheese; Sierra Cheese; Pacific Cheese; Masson Cheese; Mozzarella Fresca; and Loleta Cheese (collectively, F&A *et al*.)
2. Alliance of Western Milk Producers (Alliance), Milk Producers Council (MPC), and Western United Dairymen (WUD), (collectively, Alliance *et al*.)

Four alternative proposals were submitted:

3. Dairy Institute of California (Institute)
4. Land O'Lakes (LOL)
5. California Dairies, Inc. (CDI)
6. Humboldt Creamery (Humboldt)

A total of 33 witnesses testified including the Department's witness:

Annie Pelletier, California Department of Food and Agriculture
*Barry Murphy, Bestwhey, LLC
Jose T. Maldonado, Marquez Brothers International, Inc.
Dean Hatch, F&A Dairy of California Inc.
*Scott Hofferber, Farmdale Creamery Inc.
*Tiffany LaMendola and John Vlahos, WUD
*Bill Schiek, Institute
*Tom Wegner, LOL
Rich Ghilarducci, Humboldt
*Eric Erba and Joe Heffington, CDI
*David Larsen, Imperial Valley Cheese of California
*John Jeter, Hilmar Cheese Co.
*Joe Paris, Joseph Gallo Farms
*Kevin Abernathy and Scott Magneson, California Dairy Campaign (CDC)
*Robert Vandenheuvel, MPC
*Mike McCully, Kraft Foods
Sharon Hale, Crystal Cream & Butter Co.
*Jay Wilverding, Mozzarella Fresca
*William C. Van Dam, Alliance
*Greg Dryer, Saputo Cheese USA Inc.
Baird Rumiano, Rumiano Cheese Co.
Scott Hofferber and Michael Shotts, Farmdale Creamery Inc.
*Phillip Franco and Charlene Franco, Sierra Cheese Mfg Co. Inc.
Barbara Martin

*Sue Taylor, Leprino Foods Company
Linda Lopes, California Dairy Women's Association
*Ray Souza
Joe Mendoza Jr.
Rien Doornenbal
** indicates witnesses submitting post hearing briefs*

SUMMARY OF PROPOSALS

Table 1 outlines the proposed changes in the Class 4a and 4b pricing formula components in contrast to the current pricing formulas. In addition, the table shows the estimated impact of the changes on Class 4a and 4b prices and on Pool prices.

Table 1 - **Summary of Proposed Changes to Class 4a and 4b Pricing formulas with estimates of Class and Pool price impacts for the 60-month period Sep'02 to Aug'07**

Price impacts include variable components in some cases

	Current	F&A *et al.*	Alliance *et al.*	Institute	LOL	CDI	Humboldt
Manufacturing Cost Allowances - ¢/lb							
Cheddar Cheese	17.80¢			19.88¢	19.88¢		
Dry Whey	26.70¢	1/	19.00¢ 2/	1/	27.34¢		
Butter	15.60¢					16.07¢	
NFDM	16.00¢			16.64¢	16.64¢	16.98¢	
fob California Price Adjusters - ¢/lb							
Cheese	2.52¢			2.70¢			
Butter	1.68¢			2.80¢	2.80¢	3.97¢	
Special Plant Credits & Two-Tier Pricing							
Class 4b Plants			3/				
Class 4a & 4b Plants						4/	
Class 4a & 4b Plants							5/
Price Impacts - $/cwt.							
Class 4a	n/a			-$0.10	-$0.10	-$0.20	
Class 4b	n/a	-$0.24	$0.48	-$0.46	-$0.24		
Quota and Overbase	n/a	-$0.14	$0.20	-$0.28	-$0.15	-$0.08	-$0.02

1/ Proposed elimination of whey factor.

2/ The proposal called for "flooring" the whey factor so it is never negative. In essence, when calculating the whey factor in the Class 4b pricing formula, the price used will be the higher of $0.19 or the Western dry whey price.

The actual proposal was to set the MCA for dry whey at the MCA for nonfat dry milk plus three cents. Since the current MCA for nonfat dry milk is 16 cents: $0.19 = $0.16 + $0.03

3/ Whey factor eliminated for first 3 million pounds of milk per month.

4/ Three-year, $0.50/cwt price reduction for Classes 4a and 4b utilization in new or expanded plants.

5/ Price reduction for first 12 million pounds of milk used as Class 4a and as Class 4b.

BACKGROUND: CALIFORNIA'S DAIRY LANDSCAPE

When examining and evaluating the proposals and testimony submitted at the hearing, the Hearing Panel considered the following economic data and statistics representing the current situation of California's dairy industry. (Departmental hearing exhibit #7b contains additional, detailed economic data and statistics back to 1995.)

California Milk Production and Milk Cows
Compared to the same period in 2006, for the first seven months of 2007:

- Pool Utilization
  - All fat up 4.1%
  - All solids-not-fat (SNF) up 4.4%
- CDFA actual Milk Production up 4.6%
- USDA est. Milk Production up 4.6%
- USDA est. Cow Number up 1.0%
- USDA est. Production per Cow up 3.6%

California Class 4b: Cheese and Whey Products
Compared to the same period in 2006, for the first seven months of 2007:

- Pool Utilization
  - Class 4b fat up 2.9%
  - Class 4b SNF up 5.1%
- Product production
  - All cheese up 7.3%
  - Dry Whey **down** -19.4%

California Class 4a: Butter and Nonfat Dry Milk (NFDM)
Compared to the same period in 2006, for the first seven months of 2007:

- Pool Utilization
  - Class 4a fat up 4.9%
  - Class 4a SNF up 2.4%
- Product production
  - Butter up 8.2%
  - NFDM up 16.7%

California Class 3: Frozen
Compared to the same period in 2006, for the first seven months of 2007:

- Pool Utilization
  - Class 3 fat up 1.4%
  - Class 3 SNF up 13.3%
- Product production
  - Total Frozen up 2.0%
  - Ice Cream up 1.7%

California Class 2: Cottage Cheese and Yogurt
Compared to the same period in 2006, for the first seven months of 2007:

- Pool Utilization
  - Class 2 fat up 14.8%
  - Class 2 SNF up 8.7%
- Product production
  - All Cottage Cheese up 5.5%
  - Yogurt up 2.5%

California Class 1: Fluid Milk and Half-and-Half
Compared to the same period in 2006, for the first seven months of 2007:

- Pool Utilization
  - Class 1 fat up 2.6%
  - Class 1 SNF up 3.1%
- Product **sales**
  - All beverage milk up 0.5%
  - Half-and-Half **down** -7.1%

Cost of Producing Milk Relative to Price
Compared to the same period in 2006, for the first **six** months of 2007:

- Costs were up $1.33/cwt.
- Mailbox prices were up $3.88/cwt.

PLANT CREDITS AND MULTI-TIER PRICING

There were three proposals for price reductions and/or special credits for processors under specific conditions:

- The Alliance *et al*. proposed a credit for small cheese plants. Specifically, the effect of the whey factor in the Class 4b pricing formula would not apply to the first 3 million pounds of milk per month.
- CDI proposed a credit for new Class 4a and 4b plants (or new equipment). Specifically, the applicable class price would be reduced $0.50 per hundredweight for the first three years of the plant's operation (or installation of new equipment).
- Humboldt proposed a price reduction for small Class 4a and 4b plants. Specifically, the applicable class price would be reduced $0.58 and $0.34 per hundredweight for the first 12 million pounds of milk per month used, respectively, as Class 4a and as Class 4b.

This section of the Panel report will discuss various background issues that correspond to all three of these proposals followed by individual discussion of each issue.

Background

A Legislative and Program Background

The legislative authority to establish minimum farm milk prices based on usage was first made effective in the mid-1930s and has been in effect for over 70 years to date. The statute specifies five classified usages in which minimum farm prices are established. While there are exceptions, the following ranking (highest ranked first) generally reflects those usages that typically receive the highest prices:

Class 1: Milk used in fluid products
Class 2: Milk used in heavy cream, cottage cheese, yogurt, etc.
Class 3: Milk used in ice cream and frozen dairy products
Class 4b: Milk used in cheese, other than cottage cheese
Class 4a: Milk used in butter and nonfat dry milk (NFDM)

During the entire history of California minimum milk pricing, the statutory authority has always been interpreted and applied in the establishment of one classified price in the Stabilization and Marketing Plan. In other words one class price was established for Class 1, one class price was established for Class 2 and so forth.

Minimum milk prices brought stability to the dairy industry, but did not ensure that all producers received the same price. The price they received depended on which plant they shipped their milk to and that plant's utilization into the various classified products. Producers who shipped to plants that had high Class 1 usage would receive more revenues than plants with low Class 1 usage.

Passage of the Gonsalves Milk Pooling Act in 1967, with implementation in 1969, corrected many of these problems via the establishment of the Milk Pooling Plan. However, the pooling plan removed the economic incentives to ship to a fluid plant in order to receive pool revenues. Instead, producers had the economic incentive to ship to a local plant (manufacturing plant).

The pool system is a closed system. That is, all monies paid into the system via the class prices are paid out to producers. Likewise, any credits that might be authorized for various purposes must be accounted for as well. Failure to do so results in producer pool prices that do not accurately reflect revenues that are due producers.

Transportation Allowances and Credits

To ensure that fluid milk processors obtained sufficient milk supplies, location differentials were established to encourage the movement of quota milk to Class 1 plants. Over time, the location differentials that were used to encourage milk shipments to Class 1 plants were eventually replaced by Transportation Allowances. The April 1983 adoption of the transportation allowance was approved by a referendum vote of producers (see Appendix B).

Similarly, the differentials between the Class 1 prices in the various regions of the state provided enough economic incentives that processing plants in certain regions of the state that had lower Class 1 prices would ship milk supplies to other areas of the state that had higher Class 1 prices (location differentials). Over time, the Class 1 differentials no longer were sufficient to cover the hauling cost of these plant milk movements. The Stab Plans and Pool Plans were amended to create the establishment of transportation credits.

Transportation allowances (movement from ranch-to-plant) and transportation credits (movement from plant-to-plant) were made effective in part because of producer commitments to fluid processors that producers would ensure that sufficient milk supplies would be made available for fluid usages. The transportation allowances and credits were borne out of the need to ensure that the Class1 market would receive sufficient milk supplies. These producers' commitment was critical in obtaining the establishment of a Pool and the sharing of revenues by all producers. At the time there was no other commitment needed or necessary regarding any other credit of pool revenues for any other classified usage.

Class 1 Fortification

In the early 1960s, the California Legislature enacted legislation that would raise the solids content of fluid milk beyond the content that could reasonably be expected from typical milk production. In order to enact the legislation, a number of compromises between producer and processor interests were necessary. At the time, processors were concerned that they not only would be responsible for paying a higher Class 1 price since the price was based on the milk components, but that many processors would have to incur the additional costs of fortifying the milk supplies they received in order to comply with the new higher standard. In order to address this concern, dairy producers agreed that the minimum pricing formula would establish a fortification allowance to offset some of the additional processing costs that would be incurred. These provisions were made a part of the Stab Plan and were first made effective well before the Pool Plan was ever made effective. When the Pool Plan was eventually made effective in the late 1960s, the pooling system simply recognized the then current fortification allowance that already existed in the Stab Plan.

Establishment of Multi-Tier Pricing in other Governmental Minimum Milk Pricing Programs

For as long as the Panel is aware of, the minimum prices in the federal order milk marketing order system has consistently applied one minimum price for each classified usage in a given federal milk marketing order. Equally important, there is no state minimum milk pricing

program that the Panel is aware of that establishes more than one minimum price per classified usage in a regulated marketing area.

State and federal government agencies enacted legislation for the establishment of minimum milk prices in part to balance the tremendous difference in bargaining power between dairy farmers and dairy processors. The establishment of government mandated minimum prices was also designed to create equal raw product costs among processors and to eliminate the unfair advantage and market power that some processors could exploit simply because of their tremendous size and ability to generate higher farm revenues (processors with greater sales of Class 1 products) in the market.

The legislative intent of government regulation of minimum milk prices was to create a level playing ground for both dairy farmers and dairy processors. Dairy farmers could depend on the fact that all dairy farmers would receive the same price regardless of what processors they shipped to. Processors that manufactured a product could rely on the fact that processors making the same product were all paying the same price for their basic milk supply.

Legal Authority

The proponents testified that the current statutory authority permits the establishment of the proposed dry whey credit. Their legal counsel testified that there is no specific authorization required, the Act is intended as providing broad policy guideline, not a detailed road map, and the Secretary is empowered to adopt plan provisions that promote the purpose of the statute and are consistent with the policy guidelines set forth therein. Proponents of the plant capacity credit testified that the credit is similar to other credits that exist currently.

Opponents testified that the dry whey credit does not fall within the severely restricted classes of marketing, transportation, or processing services for which the Secretary is permitted to recognize credits. Since the dry whey credit does not therefore meet the standards prescribed under Sections 62031 and 61996 of Chapter 2, the Secretary has no power to adopt it.

The question of whether or not there is legal authority to adopt the dry whey or the plant capacity credits certainly raises the question of whether or not the legislature, in enacting the statutes, even contemplated the establishment of such credits. It is not clear that the legislature even considered the potential impact of making effective tier pricing for a specific classified usage.

For purposes of class pricing and plant utilization, the classification of milk products is defined in Chapter 2, Article 5, Code Sections 61931-61935. In some cases, classification is based not on the type of product made but on the geographic area in which it is sold. For example, yogurt is generally a Class 2 product (Section 61933), but it is a Class 4a product if it “is sold for use outside the boundaries of the United States” (Section 61935). In this case, two competing processors in the same marketing area would have different prices for the same class depending on the geographic area in which the finished product is sold. This is an example of multi-tier pricing authorized by the legislature.

Dry Whey Credit

Issue

The inclusion of the whey factor in the Class 4b formula has been an issue since it was introduced in 2003. On one hand, producers support the validity of this notion as it allows them to gain revenues from the production of whey. On the other hand, processors argue its economic soundness as a majority of cheese companies handle the whey stream coming out of the cheese production as a waste. In fact, recovering the solids from the whey stream requires significant investments that are, for the most part, only economically feasible for large size plants. While Alliance *et al.* believe that whey has a value; they also recognize that some plants might not process volumes significant enough to justify investments in whey processing equipments and that some relief should be given to the volumes below that level through credits from the pool.

Review of proposal

Following the petition submitted by F&A *et al.* to remove the whey factor from the Class 4b pricing formula, Alliance *et al.* submitted another petition to expand the scope of the hearing to the Pool Plan in order to incorporate the concept of a "dry whey credit." The thought process behind which this concept was developed is based on the group's understanding that the whey stream has a value that should be reflected in the Class 4b formula, while smaller volume cheese manufacturers do not have the ability to process their whey stream, thus not capturing any value from the marketplace. Therefore, they proposed a concept that would provide a credit for up to 100,000 lbs. of milk used to process cheese daily, which would be implemented through the pool on a SNF basis of up to 264,480 lbs. of SNF per month. The value of the credit would be equal to the whey component in the Class 4b formula ((Western Dry Whey Mostly price – MCA)*5.8/8.8) and would be offered to all cheese manufacturers for their production below the volume threshold. Therefore, this dry whey credit would be established to provide a relief to the cheese plants not processing whey while allowing producers to benefit from the value of the remainder of the milk processed into cheese.

Impact of proposal

The dry whey credit portion of the Alliance *et al.* proposal would not change the announced Class 4a and 4b prices. Its average impact on the pool price over the last five years would have been really small (-$0.01). Table 1 below shows the impact for each 12-month period.

Table 2: **Estimated Impact on the Pool Price of the Alliance *et al.* Dry Whey Credit, September 2002 to August 2007**

	Alliance *et al.*
September 2002 to August 2003	$0.00
September 2003 to August 2004	$0.00
September 2004 to August 2005	$0.00
September 2005 to August 2006	-$0.01
September 2006 to August 2007	-$0.05
Five year average	-$0.01

Discussion

As cited in the background section above, the Panel believes that the Alliance *et. al* proposal raises such serious policy questions that it would be appropriate for the State Legislature to address their proposed credit. In addition to the general legal issues cited above, the proposal raises the following specific legal issues:

- Whether or not multi-tier pricing is authorized in the current statutes for any of the class usages.
- The multi-tier pricing may raise a legal challenge as being discriminatory in nature.
- Whether or not multi-tier pricing can be applied to the establishment of minimum prices for unique dairy farm conditions (small farms, or specific farm locations).

Therefore, in light of the legal issues associated with multi-tier pricing and the Department's authority to enact the proposal, the Panel has concerns with adopting the proposed credits.

Consequently, absent clear and indisputable legislative authority, the following economic facts create ample reason to have concerns about the adoption of the dry whey credit proposal:

- All cheese plants are required to pay the established minimum price, but as proposed, non-pool plants would not be entitled to receive the proposed dry whey credit.
- The proposal would create a multi-tiered pricing system. Plants of different sizes would have different raw product costs.
- The proposal would not be consistent with the statutory mandate for providing equal raw product costing.
- The proposal would add significant complexity to the minimum pricing program and much greater regulation over the processors of dairy products.
- Depending on the difference between the price levels at each tier, it creates the potential for distorting the normal economic incentive for a plant to achieve higher economies of scale. Processing plants that would normally routinely consider plant expansion in order to reduce their unit costs might restrict expansion in order to preserve the price advantage they enjoy.

Furthermore, the Alliance *et al.* proposed that their credit did not apply to non-pool plants' milk coming from direct shippers. By placing their price reduction in the Stab Plans, non-pool plants would get the credit. If their price reduction were removed form the Stab Plans, there would be no authority for the credit in the Pool Plan. Absent legislative changes, it is not possible to limit the credit to pool plants.

With plant capacity being a major industry concern at this time, it is not appropriate to raise minimum prices for larger cheese plants, as proposed in their full proposal. Since the Alliance *et al.* proposal will reduce the whey MCA significantly (as will be discussed in the Whey factor section of this Panel report), the effect on the Class 4b price is an increase that will actually raise the price of milk for larger cheese plants that will purchase large quantities of milk beyond the proposed threshold of 100,000 lbs. of milk a day.

What is extremely clear is that the production and marketing of milk, and indeed the very nature of milk production and processing, has changed significantly from the time the statutes were first enacted. The Panel believes that the credit proposals raise such serious policy

questions that it would be far more appropriate for the State Legislature to address the issue. The Legislature has the ultimate authority to resolve such policy questions. It is typically not appropriate nor within the authority of a state agency to make such determinations.

Panel Recommendation

The Panel recommends that the dry whey credit proposal be denied.

Plant Expansion Credit

Issue

Some dairy processors have expressed concern that California's processing capacity is approaching a critical point of imbalance relative to California's total milk production. Currently, the Department may encourage additional processing capacity via an increase in the manufacturing allowance which reduces the minimum milk price for all producers. CDI testified that there is no assurance that an increase in the state's manufacturing allowances, which translates into a corresponding reduction in the minimum milk price, will actually be used by processing plants to increase the state's manufacturing capacity. There is no specific provision in the pricing or pooling programs that would only compensate those processors that expand their processing capacity, and thereby limit the negative consequence to producers.

Review of proposal

CDI proposed that an incentive be given to manufacturing plants that add processing capacity to the state, either by building a new facility or expanding an existing facility. The incentive would be in the form of a credit to the plant's pool obligation. CDI proposed that a pool credit of $0.50 per hundredweight be established. CDI proposed that the credit be placed entirely on the solids-not-fat price and would apply to eligible plants for a period of three years.

Impact of proposal

The recent history is not a valid indicator of the potential impact this proposal might have on the pool or on pool prices. Without knowledge of what new processing plants might be built or what current plants might consider expanding, there is really no way of estimating the impact. Because of the lack of data in this area, no analysis could be done for the CDI proposal.

Discussion

CDI justifies their proposal as needed to deal with industry concerns regarding plant capacity. Both the old Kraft-Visalia and DFA-Petaluma plants have been sold and brought back on line. In terms of dealing with plant capacity, restarting these older plants has as much claim on a credit as building a new plant. Usually at a higher cost, existing plants can process more milk by fully utilizing less efficient equipment and/or increasing staff levels. In terms of dealing with plant capacity, these higher costs have as much claim on a credit as building a new plant.

The CDI proposal would give a credit to processors of Class 4a and 4b products that either build a new plant or add additional processing capacity in an existing plant. The Panel views this proposal as an attempt to use pool revenues to compensate a unique subset of industry for a special purpose. Section 62720 of the Code states that no Pool Plan shall result in an unequal raw product cost between distributors in the same marketing area. Further, this credit was submitted as an alternative proposal and had little opportunity for industry discussion.

Historically, changes to the Pool Plan have always been preceded by significant industry discussion and consideration. The change from the Location Differential system to the Transportation Allowance and Sub-pool systems did not allocate money between the handlers and producers, but rather shifted money amongst producers. Attempts at making changes to the milk movement system took over two years. Much discussion occurred among industry members, public hearings were held in September 1982 and were continued to November 1982, attempts at legislation were made (SB 1545), and the passage of a producer referendum on an agreed upon system was finally implemented in 1983. A full discussion of this lengthy process is provided in a memorandum released on December 14, 1982 (see attachment B). Given that it took years of discussion to change a failing milk movement provision, the Panel thinks that it would be premature to implement such a credit at this time without similar industry participation.

The CDI proposed pool credit for plant expansion would in effect establish another pricing tier for Class 4a and 4b. Those plants that expand or are newly built during the three-year time period would essentially pay a separate minimum price because of the $0.50 pool credit. For the same legal reasons discussed previously at length in the background section and the Alliance *et al.* section, the Panel believes this proposal raises issues with regards to multi-tier pricing and the legal authority to implement the proposal.

Consequently absent clear and indisputable legislative authority, the following economic facts create ample reason to have concerns about the adoption of the plant processing capacity credit proposal:

- The proposal would create a multi-tiered pricing system. Plants of different sizes would have different raw product costs.
- The proposal would not be consistent with the statutory mandate for providing equal raw product costing.
- The proposal would add significant complexity to the minimum pricing program and much greater regulation over the processors of dairy products.

Again, the Panel believes it is very clear that the production and marketing of milk, and indeed the very nature of milk production and processing, has changed significantly from the time the statutes were first enacted. The credit proposals raise such serious policy questions that it would be far more appropriate for the State Legislature to address the issue. The Legislature has the ultimate authority to resolve such policy questions. It is typically not appropriate nor within the authority of a state agency to make such determinations.

Panel Recommendation:

The Panel recommends that the plant processing capacity credit proposal be denied.

Multi-Tier pricing

Issue

The volumes processed by cheese, butter and NFDM plants in California vary greatly between processors. Humboldt believes that the current pricing formula does not take into account the differences that exist between small and large manufacturers. In order to keep small processors viable, they propose a pricing system that would allow a higher manufacturing cost allowance for volumes of milk processed within specific thresholds. This would create a pricing formula that results in multi-tier pricing.

Review of proposal

Following the call of the hearing, Humboldt proposed an approach targeting the inequity in the current Class 4b pricing structure, which in their opinion is the difference in plant size, not whether or not the whey stream has a value. To address this issue, they suggested setting different manufacturing cost allowances based on volumes processed. Using the Department's recent manufacturing cost study and the importance of consistency between classes, they proposed the following multi-tiered Class 4a and 4b pricing formulas (*changes in italic*). Their rationale for the dichotomy is the increasing variance between small and large manufacturers.

- Class 4a fat, <u>for the first 210,000 lbs. of milk fat processed</u>
  - (CME Butter Price - $0.0168 - *$0.2061*) * 1.2
- Class 4a SNF, <u>for the first 522,000 lbs. of solids-not-fat processed</u>
  - (CA NFDM Price - *$0.2020*) * 1.0
- Class 4b product value
  - (Cheddar Price - $0.0252 - *$0.2104* (<u>first 6 million lbs. of milk processed</u>))*10.2 + (CME Butter - $0.10 - *$0.2061* (<u>first 210,000 lbs. of milk fat processed</u>))*0.27 + (Western Dry Whey - $0.267)*5.8

  For large volume plants, the formulas remain the same for products produced above the threshold.

Impact of proposal

Humboldt's size-based manufacturing cost allowances proposal would have a small impact on the pool. In fact, its average impact on the pool price over the last five years would have been -$0.02.

Discussion

A pricing structure that involves different manufacturing cost allowances within a given Class, based on volumes produced within that Class, would result in different prices paid for the same product in the same location. This price differential for the same products would create unequal raw product costs for plants directly competing with each other. In fact, plants producing within the volume thresholds in the formula would benefit from lower raw product costs, therefore discriminating against larger processing plants facing higher raw product costs for all their production above the volume threshold.

It is not surprising that the hearing record contains testimony from processors expressing concern about the discriminatory nature of establishing two separate minimum prices for

Class 4a and 4b; namely that this proposal would not be consistent with the statutory mandate for providing equal raw product costing. The multi-tier pricing may also create legal challenges due to its possible discriminatory nature. Small plants would reap greater benefits as volumes produced below the threshold would be attributed significantly higher MCAs (32%, 26% and 18% higher for butter, NFDM and cheese, respectively).

Creating a price advantage for volumes produced within a certain threshold would send the wrong market signals as favoring small volumes and would give processors a disincentive to grow past the threshold, thus distorting the normal economic incentive for a plant to achieve higher economies of scale. Processing plants that would normally routinely consider plant expansion in order to reduce their unit costs might restrict expansion in order to preserve the price advantage they receive within the volume threshold. For companies making expansion decisions, this might encourage the building of multiple individual small-size plants in order to benefit from the lower raw product costs, instead of growing within their existing facilities. This could lead to inefficiencies within the industry as growth decisions would be based on size instead of economic efficiency as a size-neutral formula would dictate.

Another concern surrounding the Humboldt proposal is that it creates an environment where small dairy processors could mistakenly believe that if it is justified for small Class 4a and 4b plants to get economic relief, then it should be reasonable for the small processors of fluid milk, yogurt, cottage cheese, or ice cream also to get a lower minimum price. Extending this further, it raises the question whether multi-tier pricing could also be established for milk supplies from small dairy farms. In addition, the proposal would add significant complexity to the minimum pricing program and much greater regulation over the processors of dairy products.

The size of plants that would be eligible for the credit does not match the size of plants that are the basis for the higher manufacturing cost allowances. Take nonfat dry milk (NFDM) and Class 4a solids-not-fat (SNF) as an example. The price reduction would apply to the first 522,000 pounds of SNF, equivalent to 5.7 million pounds per year of NFDM. Humboldt based their proposed manufacturing cost allowance of $0.202 per pound on four plants with an average size of 25.7 million pounds. Therefore, the proposed 522,000 pounds per month is too small to be effective for plants whose costs average $0.202 per pound.

Pricing and pooling are size neutral. The same pool prices are applicable to both small and large producers; the same minimum prices are applicable to both small and large processors. The Department has met its mandate provided that:

> *"… prices established pursuant to this section shall insure an adequate and continuous supply, in relation to demand, of pure, fresh, wholesome market milk for all purposes, including manufacturing purposes, at prices to consumers which, when considered with relevant economic criteria, are fair and reasonable."* Code Section 62062(b)

The Panel is of the opinion that given the specifics involved, if the Legislature intended to have multi-tier pricing based on plant size or age, then the legislature would have authorized this type of multi-tier pricing in Article 5 as it did in the case of yogurt (see page 9). Based on this evidence, the Panel is somewhat doubtful that this was seriously contemplated by the Legislature in the enactment of the minimum pricing statute. It is the Legislature and not the Department that should make this policy decision. Absent such legislative authority, there

are still concerns that create ample reasons to state that adopting a multi-tier pricing system would not be beneficial for the economic health of the dairy industry.

Panel Recommendation

The Panel recommends not using different manufacturing cost allowances based on volumes that would create multi-tiered pricing in the Class 4a and 4b formulas.

f.o.b. CALIFORNIA PRICE ADJUSTERS

Issue

For input into the pricing formula calculations, the Department requires California manufacturing plants to report the monthly Nonfat Dry Milk (NFDM) prices that they receive. The Department, however, does not require California manufacturing plants to report the monthly prices that they receive for Cheddar cheese and butter. Instead, the pricing formulas incorporate the announced national prices for Cheddar cheese and butter established by the Chicago Mercantile Exchange (CME) to calculate the monthly Class 4a and 4b prices. The use of CME prices is far more administratively efficient and enables the establishment of monthly prices on a timelier basis.

In the California Class 4a and 4b pricing formulas, f.o.b. price adjusters are subtracted from the CME monthly average prices to reflect the actual prices that California processors receive for the sales of their finished products.

California Price = CME Price – f.o.b. Price Adjuster

The Department normally reviews the f.o.b. adjusters whenever there is a hearing to consider adjustments in the Class 4a and 4b pricing formulas. In the case of Class 4a, currently $0.0168 per pound is subtracted from the CME Grade AA butter price. In the case of Class 4b, $0.0252 per pound is subtracted from the CME 40-pound block Cheddar cheese price.

In October 2007, the Department distributed a report that reflected the differences between the actual prices that California plants received and the announced CME prices both for Grade AA butter and for 40-pound block Cheddar cheese. The report reflected sales data collected for the period September 2005 through August 2007. Compared to the report released in April 2006, which reflected sales data collected for the period January 2004 through December 2005, the differences had increased between California prices received and announced CME prices.

Review of Proposals

The Department received three proposals for changes to one or both f.o.b. California price adjusters: Institute, LOL, and CDI. The Institute proposal would amend the f.o.b. adjusters for both butter and cheese, while the CDI and LOL proposals would only amend the price adjusted for butter. In addition, the Institute proposed increasing the time period of sales price data used in setting the f.o.b. adjusters from the historic 24 months to 80 months. CDI proposed that the determination of the butter f.o.b. adjuster should be based on a new methodology using a weighted average rather than a simple average. (See Table 3).

Table 3 - **Summary of Proposed f.o.b. California Price Adjusters for Butter and Cheese**

	Butter ($/lb.)	**Cheese** ($/lb.)
Current	**$0.0168**	**$0.0252**
Institute	$0.0280	$0.0270
LOL	$0.0280	No change
CDI	$0.0397	No change

Impact of Proposals

For the proposed changes to the f.o.b. California price adjusters, Table 4 shows the impact they would have had on minimum class prices and on pool prices. The analysis assumes that all other factors in the pricing formulas remain unchanged and that the proposals were in effect from September 2002 through August 2007. The Institute proposal would have decreased Class 4a and 4b prices, respectively, $0.05 and $0.02 per hundredweight, resulting in a combined $0.03 per hundredweight decrease in pool prices. The LOL proposal would have had the same impact on Class 4a as the Institute proposal, with a $0.02 per hundredweight decrease in pool prices. The CDI proposal would have decreased Class 4a prices $0.10 per hundredweight, resulting in the largest decrease in pool prices, $0.04 per hundredweight.

Table 4 - **f.o.b. Price Adjusters: Impact of Proposals on the Various California Milk Classes and Pool Prices Relative to the Current Pricing Formulas, Five Year Averages, September 2002 to August 2007**

		Class 4a ($/cwt)	**Class 4b** ($/cwt)	**Pool** ($/cwt)
Institute	Butter	-$0.05		-$0.02
	Cheese	n/a	-$0.02	-$0.01
LOL	Butter	-$0.05		-$0.02
	Cheese	n/a	n/a	n/a
CDI	Butter	-$0.10		-$0.04
	Cheese	n/a	n/a	n/a

Discussion

The Department determines the f.o.b. California price adjusters using the average differences between California prices received and announced CME prices. Historically, the Department used the simple average difference for the most recent available 24-month period to set the f.o.b. adjusters. Witnesses raised questions concerning the use of a 24-month period and the simple average:
(1) What is the appropriate time period over which the average should be taken?
(2) What is the appropriate methodology: a simple average or a weighted average?

Time Period over Which the Average Should Be Taken

The Institute stated that using an f.o.b. adjuster for Cheddar cheese based on 24-month periods results in Class 4b prices that do not correlate well with actual movement in the cheese market. Based on their analysis, the Institute proposed that the Department increase the time period for establishing the f.o.b. adjuster from 24 months to 80 months. The Institute testified that the resulting f.o.b. adjuster would better reflect the pattern of cheese price movement in the market. The Institute did not perform this same analysis for butter. For consistency however, they recommended that this methodology be applied to butter as well.

CDI opposed using any longer time period:

"…. transportation costs make up the majority of the embedded costs for the 'Chicago Mercantile Exchange – California prices received' difference. Furthermore, the cost of moving finished product to customers has increased significantly since 2001."

At this time, the Panel believes that a 24-month period is more reflective of marketing conditions. The Panel, however, also believes that this issue needs review with the active participation of all stakeholders.

Methodology: A Simple Average or a Weighted Average

CDI has repeatedly requested replacing the simple average with a weighted average. CDI made the point that weighted averages generally are more representative than simple averages. Weighted averages are more reflective of the monthly sales volumes for butter. CDI testified that their proposed weighted average method would also eliminate a possible bias in the current weighted average.

CDI indicated that in the longer term, they would like the f.o.b. adjuster for butter to use a comparison between weekly California sales data and weekly CME prices. CDI prefers using weekly data because butter sales are made and adjusted on a weekly basis rather than a monthly basis.

The hearing record contains monthly data based on the difference between California prices received and announced CME prices using a simple average and two different weighted averages. Table 5 illustrates the simple average and the two weighted averages. For simplicity, the two weighted averages are called current and proposed, respectively, for the method used prior to this year and for the method suggested by CDI.

Table 5 - **Twenty-four month average differences: actual prices that California plants received less the announced CME prices for Grade AA Butter and Cheddar Cheese, September 2005 through August 2007**

Average	Butter ($/lb.)	Cheese ($/lb.)
Simple	-$0.0309	-$0.0252
Current Weighted	-$0.0308	-$0.0267
Proposed Weighted	-$0.0408	-$0.0246

When comparing the three methods of calculating the average difference between the California prices received and announced CME prices for cheese, there is not much variation. All three methods track similarly. Concerning butter, the simple average and the current weighted average again yield similar results on a year-to-year basis. The proposed new weighted average, however, varies greatly from the other two methods on a year-to-year basis.

The hearing record reflects that the commercial markets for butter and Cheddar cheese are uniquely distinct. The two markets may be so uniquely different that a single method of establishing the f.o.b. adjuster may not be appropriate for both commodities.

The Panel concurs with the CDI testimony that much more investigation and review needs to be made of the methods used to determine the f.o.b. California price adjusters. The Panel believes that this review should be made with the active participation of all stakeholders.

Stakeholder meetings should be held to review the price data used in the f.o.b. adjuster calculation. With plants already submitting price reports to NASS on a weekly basis, the adoption of weekly or monthly mandatory reporting of California Cheddar cheese and butter sales information could be discussed. The Department already collects data for the calculation of a California Weighted Average Price (CWAP) for NFDM. Development of a CWAP for butter and Cheddar cheese would be preferable to the continued controversy at hearings about the appropriate method of calculating the f.o.b. adjusters

Given the above discussion, it is not appropriate to make major changes in the methodology at this time. Until there is a full industry review, the Panel recommends continued use of a 24-month simple average.

Panel Recommendations

The Panel recommends increasing the f.o.b. California price adjuster for butter to $0.0309 per pound. The Panel recommends no change in the f.o.b. California price adjuster for Cheddar cheese, as the current value of $0.0252 per pound is the same as the simple average of the most current 24 months.

WHEY FACTOR IN THE CLASS 4b PRICING FORMULA

Issue

Since the Department first developed a Class 4b pricing formula in the late 1980s, the appropriateness of the inclusion of a whey factor has been an issue. This has been especially true after the addition of a whey factor to the formula as a result of the January 2003 hearing. Producers view the cheese, the whey cream, and the wet-skimmed whey as legitimate sources of producer revenue under minimum pricing. Processors view the wet-skimmed whey as a cost center rather than a source of revenue. Given the competing interests of producers and processors, it is difficult to establish a fair and reasonable value for whey in the Class 4b pricing formula.

The issue starts with the nature of cheese production. In the cheese making process, it is impossible to capture all the vat milk solids in the final cheese product. These residual milk solids are contained in the whey stream (whey cream and the wet-skimmed whey) which is the byproduct of making cheese. (See Table 6)

Table 6 - **Approximate Distribution of Milk Solids in Cheese Processing**

	Fat (lb)	Protein (lb)	Sugar & Ash (lb)	Total Solids (lb)	Water (lb)	Total Weight (lb)
Vat Milk	3.50	3.20	5.50	12.20	87.80	100.00
Cheese	3.26	2.43	0.26	5.95	3.80	9.75
Whey Cream	0.24	trace	trace	0.24	0.36	0.59
Wet-Skimmed Whey	0.01	0.77	5.24	6.02	83.64	89.66

Recovering these milk solids from the whey stream is an expensive proposition, involving large capital investments and huge ongoing energy costs. Economies of scale are very important. Processing of the whey stream starts with a separator, which produces whey cream and wet-skimmed whey. The wet-skimmed whey can then be processed by one of three methods:

- Making dry whey (12 percent protein) requires a two-stage evaporation processing followed by drying.
- Making whey protein concentrate (WPC: 29 to 89 percent protein) requires membrane filtration and separate drying of the protein and lactose streams.
- Making whey protein isolates (WPI: 90+ percent protein) requires an additional step to remove almost all the residual fat.

Historically, cheese processors treated wet-skimmed whey as a waste disposal issue rather than taking the economic risk of attempting to recover the solids components. Very few cheese processors were willing to make the sizeable capital investment to recover what was then the relatively small value in the wet-skimmed whey. With increasing environmental regulations, the cost of disposing of the wet-skimmed whey grew considerably. Still, only larger cheese operations could achieve the economies of scale to make it economically feasible to recover the solids in the wet-skimmed whey. Very few cheese processors make dry whey and there is no standard for whey protein concentrate (WPC). Thus, processors continue to raise questions as to whether or not it is appropriate to have a whey factor in the Class 4b pricing formula.

The Department has performed manufacturing cost studies to determine the processing cost for converting the whey stream into dry whey for the last four years (Table 7). The limited number of dry whey plants and the statutory requirement regarding the disclosure of confidential information may limit future release of the Department's dry whey processing costs in future years.

Table 7 - **Dry Whey, Historic Summary of Weighted Average Manufacturing Costs**

Study Period	Release Date	Cost Per Pound	Number of Plants
Jan-Dec 2003	Nov-04	$0.2675	4
Jan-Dec 2004	Nov-05	$0.2673	3
Jan-Dec 2005	Nov-06	$0.2851	3
Jan-Dec 2006	Sep-07	$0.3099	3

Costs include processing labor, non-labor processing, packaging, general & administrative, and return on investments.

Review of Proposals

Both LOL and the Alliance *et al*. proposed changes to the manufacturing cost allowance (MCA) for dry whey. The latter also wanted to floor the Western dry whey price at their proposed MCA. Finally, F&A *et al*. and the Institute both proposed eliminating the whey factor from the Class 4b pricing formula (See Table 8). (The Alliance *et al*. proposal to establish a credit to cheese processors for the first 100,000 pounds of milk from the pool is discussed in a previous section.)

Table 8 - **Summary of proposals for modification to the Whey Factor in the Product Value portion of the Class 4b Pricing formula**

Current Whey Factor
(Western Dry Whey - $0.267) x 5.8

F&A *et al.* **and Institute Proposal for Whey Factor**
Eliminate the Whey Factor

LOL Proposal for Whey Factor
(Western Dry Whey - *$0.2734*) x 5.8

Alliance *et al.* **Proposal for Whey Factor** [1/]
(Western Dry Whey - *$0.19*) x 5.8
Western Dry Whey is floored at $0.19

[1/] The actual proposal was to set the MCA for dry whey at the MCA for nonfat dry milk plus three cents. Since the current MCA for nonfat dry milk is 16 cents: $0.19 = $0.16 + $0.03

Impact of Proposals

It is difficult to compare the price impacts of the proposals for the whey factor in the Class 4b pricing formula. The proposals of F&A *et al*., the Alliance *et al*., and the Institute all vary over time in terms of their impacts, and the variation in time differs among them. On an average basis for a 60-month period, Table 9 approximates the impact of the proposed changes to the whey factor. The analysis assumes that all other factors in the pricing formulas remain unchanged and that the proposals were in effect from September 2002 through August 2007. Except for the LOL proposal and the MCA portion of the Alliance *et al*. proposal, these impacts will vary from month-to-month.

Table 9 - **Summary of Changes in Class 4b and Pool Prices resulting from Proposed changes to the Dry Whey Factor, 60-month Averages, September 2002 to August 2007**

		Class 4b ($/cwt.)	**Overbase Quota** ($/cwt.)
F&A *et al.* and **Institute**	No Whey Factor	-$0.24	-$0.14
LOL	MCA = $0.2734	-$0.04 [1/]	-$0.02
Alliance *et al.*	MCA = $0.19	$0.44 [1/]	$0.21
	Floor	$0.04	$0.02
	Both	$0.48	$0.23

[1/] These price changes are constant through time, all others vary from month-to-month.

Discussion

Dry Whey Yield

The current whey factor in the Class 4b pricing formula takes the form:

(Western Dry Whey Price less $0.267) times 5.8

Hearing testimony stated that California plants making dry whey do not achieve the 5.8 yield:

- F&A: "[The formula has a] 5.8 yield factor, when F&A is only able to realize a 4.7 yield factor."
- Farmdale: "[Our yield is] only 2.5, maybe 3.0 … at best … not nearly achieving the presumed … 5.8 yield."

At the time the Department incorporated the current whey factor into the formula, the Department lacked data or analysis to determine a dry whey yield appropriate to California. Now, the statements from witnesses and the Panel's review of Departmental data strongly suggest that the 5.8 yield is over stated.

Small and Medium Volume Cheese Plants

Witnesses used various size categories to classifying cheese plants as to size. For their small cheese plant credit, Alliance *et al*. used less than 0.1 million pounds of milk per day. Based on the minimum size needed to install equipment to make a dry form of whey economically,

Bestwhey and Marquez Brothers used more than one million pounds of milk per day. (One million pounds is also consistent with the Departmental data (See Table 12). Combining their various approaches, the Panel used three size categories for the discussion in this section (See Table 10):

Table 10 - **Size Ranges of California Cheese Plants**
May, June, July and August 2007

	Number of Plants	Receipts Daily (mil. lb.)	Receipts Monthly (mil. lb.)
small cheese plants	35	0.0 to 0.1	0 to 3
medium cheese plants	13	0.1 to 1.0	3 to 30
large cheese plants	13	over 1.0	over 30
California Cheese Plants	61		

Not all cheese plants process their wet-skimmed whey into a dry form of whey. For the state's 61 cheese plants, 77 percent by number and 11 percent by volume do not process their wet-skimmed whey into a dry form of whey (See Table 11).

Table 11 - **Milk Receipts for California Cheese Plants**
May, June, July and August 2007

	Number of Plants		Average Monthly Receipts (mil. lb.)	
Cheese plants making a dry form of whey	14	23%	1,436	89%
Cheese plants **NOT** making a dry form of whey	47	77%	169	11%
California Cheese Plants	61	100%	1,605	100%

The 47 small- and medium-volume plants do not recover a dry form of whey from their wet-skimmed whey, and some of the other 14 plants do not fully recover the SNF from their wet-skimmed whey. In California, this fact is reflected in the low recovery of SNF from the whey stream. In 2006, Class 4b utilization was 1,623 million pounds of SNF. A reasonable estimate is that 1,086 million pounds entered the whey stream. Based on production in 2006, dry forms of whey (including animal feed) accounted for 754 million pounds of SNF. Thus, 332 million pounds of SNF, 31 percent of the total, were not recovered.

Given the current dry whey factor, any increase in the price of dry whey simply increases the raw product cost of milk for these cheese plants. When the dry whey price peaked in June 2007 at $0.82 per pound, it increased the minimum Class 4b price by $3.23 per hundredweight, which is equivalent to an increase of $0.32 per pound of cheese. Given that the pricing formula's current MCA is only $0.178 per pound of cheese, the available plant margin is not sufficient to cover the per unit processing costs of these cheese plants. The Alliance *et al*. proposal to cover the first 100,000 pounds of milk received by cheese processors is an acknowledgment by producer organizations that the current whey factor is creating financial difficulties for small cheese processors.

At the hearing, there was testimony that whey processing was only cost effective for plants processing over one million pounds of whey per day (equivalent to 1.1 million pounds of milk per day). Table 12 supports this statement:

- For the 61 cheese plants in California, only 14 process wet-skimmed whey to a dry form of whey
- Only one plant processing over one million pounds per day did not make a dry form of whey
- Of the 14 plants making a dry form of whey, only two processed less than one million pounds per day
  - While under a million pounds per day, these other two plants are still fairly large, processing 0.64 and 0.86 million pounds of milk per day

Table 12 – **Pounds of Milk[1/] Processed into Cheese**
Sorted by plant size; MPB handler data for May, June, July and August 2007

Pounds per Month		Plants Making		Average per plant		Percent	
From (lb)	To (lb)	Cheese	Dry Form of Whey[2/]	Monthly (lb)	Daily (lb)	Group	Total
0	¼ million	20		66,408	2,160	0.1%	0.1%
¼ million	½ million	4		409,423	13,315	0.1%	0.2%
½ million	1 million	5		739,569	24,051	0.2%	0.4%
1 million	1½ million	3		1,337,062	43,482	0.2%	0.7%
1½ million	3 million	3		2,426,363	78,906	0.5%	1.1%
3 million	10 million	7		6,837,179	222,347	3.0%	4.1%
10 million	30 million	6	2	19,441,031	632,229	7.3%	11.4%
30 million	60 million	5	4	43,164,743	1,403,731	13.4%	24.8%
60 million	100 million	3	3	85,622,190	2,784,461	16.0%	40.8%
Over 100 million		5	5	189,932,136	6,176,655	59.2%	100.0%
Average all Plants				**26,308,383**	**855,557**		
Total all Plants		**61**	**14**	**1,604,811,371**	**52,188,988**		

[1/] This is on a milk equivalent basis. These figures are not pounds of fat or SNF.

[2/] Does not include plants making an intermediate product such as condensed skim whey for shipment to another plant for final processing.

Note: Data does not include condensed skim, RO milk, or UF milk sold to, or received by cheese plants.

Dry Whey as the Basic Commodity made from Wet-Skimmed Whey

The current formula assumes that the price of dry whey fairly represents the basic commodity value for all wet and dry forms of whey. However, neither dry whey nor any other dry form of whey fairly represents the value of the actual spectrum of dry products produced by California cheese plants. Of the fourteen plants making a dry form of whey, six make two different products, and these six plants do not make the same two products. Just over half the plants make whey protein concentrate with a protein test of 50.0-89.9 percent, but this is not a standardized product. Depending on the end user, the protein content could be 50 percent, 70 percent, 89 percent or anything in between (See Table 13).

Table 13 - **Finished Products made from Wet-Skimmed Whey in 2006**

Plants Making		Plants Making	
One Product	8	Dry Whey	5
Two Products	6	WPC-low	6
Total Plants	14	WPC-high	8
		WPI	1

Includes Protein Products
- Dry Whey
- Whey Protein Concentrate 250-49.9% (WPC-low)
- Whey Protein Concentrate 50.0-89.9% (WPC-high)
- Whey Protein Isolates (WPI)

Combines Human and Animal Grade
- only one plant exclusively makes animal grade

Excludes byproducts
- Delactose Permeate Whey
- Lactose Powder
- Deproteinized Whey

Based on protein recovery, dry whey represents only 13 percent of all products produced from the wet-skimmed whey. Whey protein concentrate (WPC) accounts for the remaining 87 percent (20 and 67 percent, respectively, for low and high protein test WPC). Additionally, the production of dry whey is declining in California:

- In 2003 when the whey factor was added to the Class 4b pricing formula, there were five cheese plants making dry whey. By 2008, there will only be two plants.
- Over the last five years, dry whey production has:
  - Declined 21 percent from 2002 to 2005 (2002 was the peak of dry whey production),
  - Declined 10 percent from 2005 to 2006, and
  - Declined 19 percent for the first seven months of 2007 compared to the same period in 2006.

The price of dry whey is not a good surrogate for the price of WPC, represented here by the simple average of the mostly price range for WPC-34 as reported weekly by Dairy Market News:

- Dry whey prices went **up** (total +4.6¢/lb) while WPC prices went **down** (total -15.9¢/lb) for the seven months from July 2005 through February 2006.
- Dry whey prices went **down** (total -3.0¢/lb) while WPC prices went **up** (total +22.4¢/lb) for the five months January through May 2000.
- For the five years from January 2000 through July 2006, the relationship between changes in dry whey prices and changes in WPC prices was weak.

The whey factor in the Class 4b pricing formula assumes that dry whey is the basic, lowest valued commodity product from wet-skimmed whey, however:

- For the 47 plants not making a dry form of whey, the June 2007 Class 4b price potentially added $3.22 per hundredweight of unrecoverable costs. Even if they had a market for their wet-skimmed whey, it would not have returned them anywhere near $3.22 per hundredweight (equivalent to $0.32 per pound of cheese).
- For the four cheese plants making dry whey in 2007, at least two had reported processing costs exceeding the manufacturing cost allowance. Two dry whey processors said they did not achieve the assumed yield of 5.8 pounds per hundredweight. It is unknown how reflective Dairy Market News (DMN) Western dry whey prices are of prices actually received by California plants. Unlike the CWAP for NFDM, the DMN prices for dry whey are not an audited spot market. The CME prices are spot markets, but they are adjusted

by f.o.b. adjusters, which are based on audited sales of California butter and Cheddar cheese.
- For the plants making other dry forms of whey in 2007, prices for these products were below prices for dry whey, on a dollar per pound of protein basis. Thus even for plants making WPC, their investments were at risk.

Based on the Panel's analysis of the hearing record, the Panel is of the opinion that the current whey factor in the Class 4b pricing formula has probably caused negative cash flows for most California cheese processors during 2007. It certainly has caused financial difficulties for those smaller cheese plants that process less than one million pounds of milk per day. The whey factor provides such potential economic risks for cheese plants that there is little economic incentive for future investment in plants of any size.

By 2008, the number of plants that will process dry whey is expected to fall below the numbers required to release average plant cost data without releasing confidential information. To address this issue, there were two proposals to set the MCA for dry whey equal to the MCA for nonfat dry milk plus a differential:
- plus $0.030 per pound by the Alliance *et al*., and
- plus $0.107 per pound by LOL

There was, however, very little objective data in the hearing record to justify these proposed differentials. The LOL proposal was based on the current relationship between the MCAs for NFDM and dry whey, but current relationships are not good predictors of the future. The Alliance *et al*. proposal was based on relationships between NFDM and dry whey plant costs in other parts of the country; as California dry whey plants are smaller than the national average, this is not a valid comparison.

Dry whey is not the basic commodity reflecting the underlying value of wet-skimmed whey. The whey factor in the Class 4b pricing formula does not work in the manner it was intended. It does not provide a fair balance of competing interests between producers and processors. It is in California's long-term interest to have pricing formulas that both encourage retention of current capacity and encourage investment and expansion of both cheese plants and butter/powder plants.

Finally, the Alliance *et al*. proposed a floor to prevent the whey factor from having a negative impact on the Class 4b price. Over time with the current whey factor, both producers and processors share in market price risk:
- In 2002-03 and 2003-04 the processors benefited from the dry whey factor
- In 2005-06 and 2006-07 producers benefited from the dry whey factor

The floor proposed by the Alliance *et al*. would have eliminated the price risk to producers in 2002-03 and 2003-04. Processors would still have had a price risk in 2005-06 and 2006-07.

<u>The Value of the Wet-Skimmed Whey</u>

The Panel believes that wet-skimmed whey does have a value. Some plants have a market for their wet-skimmed whey as animal feed. It is unclear, however, to what extent the 47 small- and medium-volume cheese plants, plants processing less than one million pounds of milk per day, have such access to this market. Anecdotal testimony of small- and medium-volume cheese processors at the hearing clearly shows that some processors do not have a

market for their wet-skimmed whey. Setting a value for wet-skimmed whey is a balance between those small and medium cheese processors with access to this market and those who lack such access.

Processors argued:

- Bestwhey, LLC: "*Raw whey has zero or negative value in its unprocessed form.*"
- Farmdale: "*Whey has little or no value in itself except that which is created by value-added processing.*"
- Leprino: "*Dilute whey from a cheese vat has no value in the marketplace.*"

Everything has a value, even if it is a salvage value. Several cheese processors cited the article by John Umhoefer in Cheese Market News (August 3, 2007):

> "WCMA [Wisconsin Cheese Makers Association] asked five plants for a snapshot of the value they earn for wet, skimmed whey. In June, this product earned between 10 cents and 20 cents per pound of solids compared to the 72 cents per pound for dry whey noted by NASS."

Some producers acquire wet-skimmed whey for use as an animal feed. In some cases, producers pay nothing for the wet-skimmed whey. "*We currently provide the liquid whey to a local farmer at no return to our cheese plant*" (Imperial Cheese). Prices vary greatly when purchased by producers, and wet-skimmed whey is generally only purchased by dairies with at least 500 cows. (This information is based on detailed, confidential data from the latest Departmental Cost Comparison Summary.)

Summary

The current whey factor in the Class 4b pricing formula that uses a dry whey specific price, MCA, and yield is not sustainable:

- the current formula is in itself flawed:
  - the yield is not representative of what processors testify to as actual plant yields,
  - the price is not representative of prices received by California cheese plants for dry forms of whey,
  - the MCA is based on actual costs for dry whey plants in California, but these costs are high because most large cheese plants with potential economies of scale do not make dry whey.
- most plants do not process wet-skimmed whey into a dry form of whey,
- those plants making a dry form do not make dry whey.

Those plants making a dry form of whey do not make a standard product or set of products. Thus, it is not possible to develop a new factor using an alternative dry form of whey with its own price, manufacturing cost allowance, and yield. MPC made such a proposal at the June 2006 hearing.

Some small- and medium-volume cheese processors are able to sell their wet-skimmed whey to producers as an animal feed. The Panel believes there is a value for wet-skimmed whey that strikes a balance among those cheese processors making a dry form of whey, those processors selling wet skimmed whey as animal feed, and those processors with no market opportunity for their wet-skimmed whey.

After carefully weighing all the relevant economic factors, the Panel believes that $0.10 per hundredweight as the fixed whey factor is an appropriate figure. Replacing the highly volatile whey factor with a fixed value would provide constant value to producers. It would limit the negative impact on producers of highly volatile whey prices. It would help to avoid the negative consequences that impacted small- and medium-volume cheese processors during 2007. If the $0.10 cent per hundredweight fixed whey factor had been in place over the last 60 months, it would have resulted in higher prices to producers than the current whey factor in three of the last five years (2002-03, 2003-04, 2004-05). It would have also prevented the negative cash flow of many processors in 2006-07.

If the formulas currently in place had been in place over the last 60 months, Class 4b prices would have averaged $0.62 per hundredweight below federal order Class III prices. Just by replacing the current whey factor with a fixed whey factor of $0.10 per hundredweight, Class 4b prices would have averaged $0.78 per hundredweight below federal order Class III prices. Remember, however, that the California minimum price is a market-clearing price while the federal order price is not. The fact that cheese processors that operate under the federal order may avoid the responsibility of paying the federal order minimum price is sufficient reason to justify the increasing spread between Class 4b and Class III prices.

In this context, the Panel is using the term “market-clearing price” to mean the price at which supply equals demand. At that price, the sellers are willing to supply exactly the quantity of goods that the buyers are willing to purchase. In the dairy industry, the market clearing price is the price at which processors are willing to buy all the milk that producers are willing to sell. In the situation under the California regulated system of classified pricing, the minimum Class 4a/4b prices must be low enough so that manufacturing plants are willing to buy all the milk that is not used in Classes 1, 2 and 3.

Panel Recommendations

The Panel recommends that the current whey factor be removed and replaced with a fixed whey factor of $0.10 per hundredweight.

MANUFACTURING COST ALLOWANCES IN CLASS 4 PRICING FORMULAS

Issue

This section of the Panel report addresses the manufacturing cost allowances (MCA) for butter, nonfat dry milk (NFDM), and Cheddar cheese. Discussion of the whey factor in the Class 4b pricing formula is addressed in a previous section of this Panel report and is therefore not addressed in this section.

California's current end-product pricing formulas start with the wholesale commodity prices for Grade AA butter, NFDM, and Cheddar cheese, and dry whey and subtract a MCA to determine the value (price) for milk. In order to establish the MCA for the Class 4a and 4b pricing formulas, the Department compiles and considers annual manufacturing costs for butter, NFDM, Cheddar cheese, and dry whey. The Department has a long-standing history of relying on the processing cost study data combined with the numerous, relevant economic factors to establish the MCA for the commodities. Once the Department establishes the MCA for the commodities, they remain in the pricing formulas until amended via a new public hearing.

Review of Proposals

There were six formal proposals to adjust the MCA for butter, NFDM, and Cheddar cheese that are summarized in Table 14. LOL and the Institute proposed increasing both the NFDM MCA and cheese MCA to match the 2006 weighted average manufacturing cost as released by the Department prior to the hearing, which are $0.1664 and $0.1988 respectively. CDI proposed increasing the MCA for butter and NFDM to $0.1607 and $0.1698, respectively, in order to match the weighted average costs of the CDI butter/NFDM plants as submitted in their testimony. Humboldt proposed two different MCA levels for butter, NFDM, and cheese based on different thresholds of milk volumes processed in the month. Because the Humboldt proposal is discussed in its own section of this Panel report, further discussion will not be made here. Additionally, Alliance *et al.* and LOL proposed distinct changes to the dry whey MCA, which is discussed in its own section of this Panel report. The differences between the proposals discussed in this section are quite narrow; with all the proposals based upon either the weighted average costs from the Department's manufacturing cost study from 2006 or the weighted average costs of CDI's own plants.

Table 14 **- Comparisons of Proposed MCA for Butter, NFDM, and Cheddar Cheese**

Butter	MCA	MCA / WAC [1/]	Volume [2/]	ROI [3/]
Current	$0.1560	1.14	61%	26.20%
CDI	$0.1607	1.17	61%	30.73%
NFDM				
Current	$0.1600	0.96	28%	-0.4%
Institute	$0.1664	1.00	80%	5.3%
LOL	$0.1664	1.00	80%	5.3%
CDI	$0.1698	1.02	91%	8.3%
Cheese				
Current	$0.1780	0.90	0%	-10.4%
Institute	$0.1988	1.00	71%	7.7%
LOL	$0.1988	1.00	71%	7.7%

1/ WAC is the weighted average cost as released in the Department's annual manufacturing cost study

2/ Volume covered calculation includes a 6.48% ROI

3/ Imputed ROI calculation **excludes** the 6.48% ROI

Impact of Proposals

The MCA for butter and for NFDM proposed by CDI would decrease the Class 4a price by $0.11 per hundredweight, whereas the NFDM MCA proposed by LOL and the Institute would decrease the Class 4a price by $0.06 per hundredweight (neither the Institute nor LOL proposed a change to the butter MCA). The cheese MCA proposed by LOL and the Institute would decrease the Class 4b price by about $0.21 per hundredweight. Obviously, in order to understand the full impact of each organization's proposal, one must combine the changes in class prices resulting from the proposed changes to the f.o.b. adjusters and also the whey factor that are discussed in other sections of this Panel report (see Table 1).

Discussion

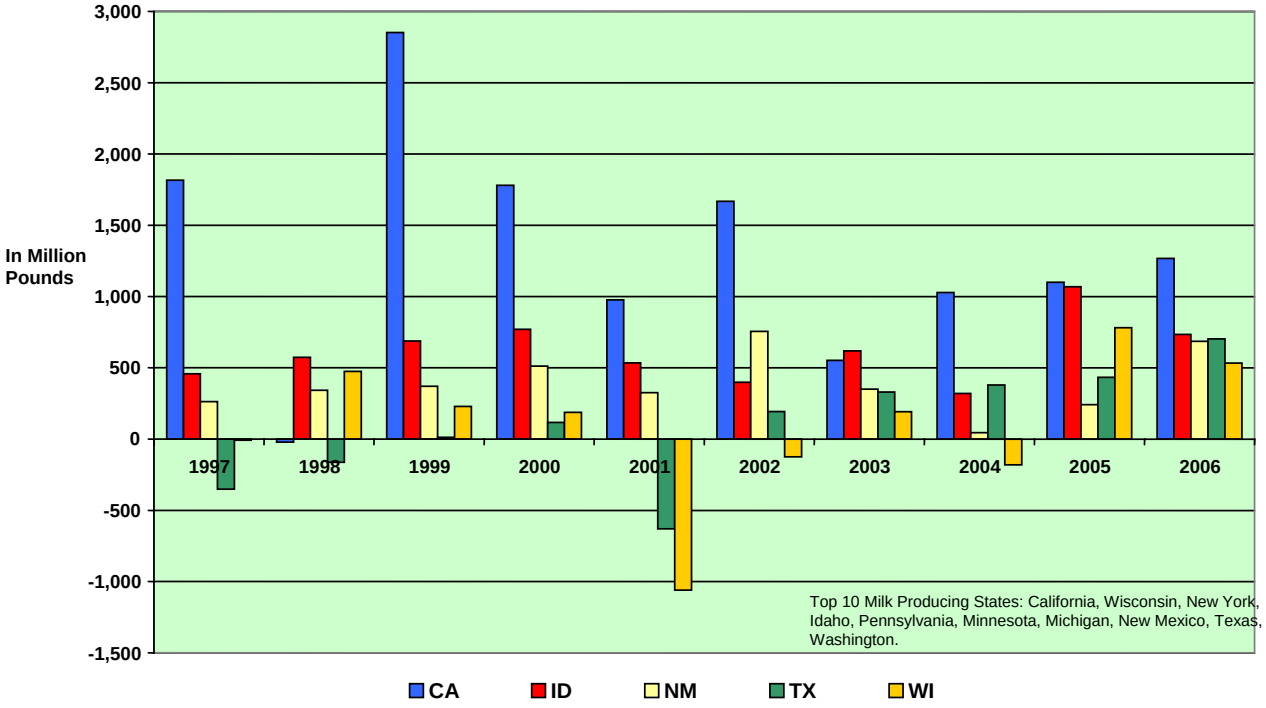
There are two issues derived from the hearing record that concern the Panel. First, there is sufficient evidence to show that milk is not being marketed in an orderly manner as mandated by legislation. This is troublesome because one of the important foundations of the legislation governing the dairy industry is orderly milk marketing. Second, the MCA in the current pricing formulas are not providing an adequate operating margin to promote economic viability for processors.

The Panel's concern that milk is not being marketed in an orderly manner is evidenced by the problems California has experienced balancing the milk supply, by distressed milk leaving the state at a discounted price, and milk leaving the farm without being processed. The problems

balancing the state's milk supply is characterized by milk production growth outpacing manufacturing growth.

Statistics show that milk production in California has been consistently growing for many years. So far for every month in 2007, milk production has been higher compared to the same month in 2006. Additionally, except for July 2006 when record high temperatures occurred, milk production in every month in 2006 was also higher when compared to the same month in 2005. As illustrated in Table 15, milk production has grown by 1.03 billion pounds, 1.10 billion pounds, and 1.27 billion pounds respectively for 2004, 2005 and 2006. Additionally, the table indicates that California's growth in milk production has outpaced the other large output milk producing states considerably over the last ten years. All estimates show milk production for 2008 will be higher than 2007. Based on the consistent growth trend over the last decade, the Panel sees little evidence that California's milk supply will not continue to increase in the near future.

Table 15: **Absolute Growth in Milk Production from Previous Year, 10 Years, 1997-2006**
California, Idaho, New Mexico, Texas, Wisconsin



California's ability to process its expanding milk supply has been limited by the lack of processing growth. For example, the new CDI plant in Visalia is set to open at the end of the year, but the Golden Cheese plant in Corona is closing, neutralizing the increased processing capacity. Besides these plants, there have not been any announcements of significant new construction. It is in the industry's best interest in the long term to process all of the milk produced in the state. But, given the lack of any new processing construction and the Panel's belief of continued milk production growth in the future, eventually the milk supply will exceed California's processing capacity on an ongoing and permanent basis, which causes disorderly milk marketing. The Panel believes there are signs that indicate this is already occurring based upon testimony given during the hearing.

Reports of significant quantities of distressed milk leaving the state are a sign of disorderly milk marketing conditions. In their post-hearing brief, Gallo advised that their milk supply has been long and they have been forced to ship milk out of state to Arizona at a transportation cost in excess of $4.00 per hundredweight, while receiving a milk price $2.22 per hundredweight under the Federal Order Class IV price. In their post-hearing brief, Kraft advised that the cost of moving milk from Tipton to Jerome County, Idaho is $3.30 per hundredweight for transportation, while the milk price is about $2.00 per hundredweight under Federal class prices. Crystal testified that during the summer of 2007 more than 25 percent of their total milk volume had to leave the state due to lack of a processing option in the state, which cost an estimated $2700 per load plus another $1100 in other discounts. In addition, Hilmar testified that their Texas plant is receiving surplus California milk as well.

In their testimony, Crystal provided specific details showing the problems they experienced handling their milk over the summer of 2007. Two troubling details apparent in their account are: 1) Crystal had no California processing plants willing to take milk; and 2) transporting trucks moving milk out of state were running at capacity due to excess milk from other organizations that needed an outlet for their milk. The testimony of Crystal indicates that there were other organizations experiencing the same two issues of handling or balancing milk and shipping milk out of the state.

These accounts are not only indicative of a supply/demand imbalance, but also indicative of two negative consequences for stakeholders in California. First, the revenue received for this distressed milk going out of the state is drastically discounted. The combination of the reduced price for the milk and the additional transportation cost clearly show that the value of this milk is highly diminished. Second, since the distressed milk is purchased at a discount by out-of-state processors, which means a lower raw product cost for them, the cost of their finished product is reduced and that puts them at a competitive advantage over California processors producing the same product. This implies that out-of-state processors would have a competitive advantage in the finished product marketplace in California based upon their purchase of discounted California milk. In essence, California processors who face a higher raw milk price are forced to compete against out-of-state processors purchasing California milk at drastically discounted prices. These consequences negatively affect both producers and processors and therefore is a concern for the California dairy industry.

Another sign of disorderly milk marketing is milk leaving the farm but not being processed. In Kraft's post-hearing brief, they supplied commentary from the Dairy Market News that showed farm milk not being processed more frequently in 2007 compared to 2005 and 2006. Additionally, there was testimony given that some farm milk was going to calf ranches instead of a processing facility. The obvious concern with milk not being processed is the adverse financial effect it imposes on producers who receive little or no value for the milk, as a direct shipper, or reduced revenue as a member of a cooperative.

CDI testified that their plants run at full capacity almost all the time as they try to balance the state's milk supply. Both Kraft and Institute in their respective post-hearing briefs provided excerpts and an accounting of the increased mention of milk balancing issues in California as reported in the Dairy Market News over the last 3 years. The Dairy Market News has increasingly cited milk supply and balancing issues in California. On another note, in response to the increased problems with balancing milk, it appears milk restrictions are beginning to occur. The Panel has become aware that multiple entities in California are beginning to restrict the milk they will accept from their producers. One such entity is Nestle who wrote a letter to the Institute, which was attached to the Institute post hearing brief that

shows they have asked their producers to cut milk production by 10 percent by November 2007, to relieve their supply burden. In essence, it appears that California has reached a point where milk is overcoming its ability to be processed, as milk is generally searching for a "home," compared to some other parts of the country where this may not be an issue and the processor is the entity seeking out the milk supply.

Besides distressed milk, processors argued that the state's lack of processing growth is caused by plant closures originating from unfavorable investment conditions that impede new plant construction or expansion in the state. LOL cited the loss of cheese processing plants over the last few years by citing the closure of the Suprema, Sorrento, Gustine, and Golden Cheese plants respectively in 2002, 2003, 2005, and early 2008 (possibly late 2007). Hilmar also expressed similar concern in their testimony based upon cheese plants in the state that have been closing. Mozzarella Fresca advised in their post-hearing brief that they closed their Turlock operation in June 2007 and moved that related cheese production out of state to Wisconsin. Additionally, they advised that they have moved about 6 percent of their Tipton cheese production to their Idaho facility. Moreover, various cheese processors belonging to the group of petitioners testified that they cut back on the amount of milk they purchased in order to reduce costs associated with the Class 4b price towards the end of summer. In addition, they testified that based on the current Class 4b formula, they will not be able to remain in business if current conditions persist.

Besides plant closures, processors argue that California is not an ideal location for new plant expansion. In their post-hearing brief, Kraft attached an article from the April 2006 *Dairy Foods* magazine that outlined 41 planned dairy plant construction or expansions at that time. Of the 41, only 3 were plants in California and only the CDI Visalia plant was set to add any meaningful capacity to the state. Leprino testified that they are in the process of identifying the location for additional plant capacity, but are not considering California locations due in part to the raw product costs that are borne by the milk pricing formulas. Imperial Valley Cheese testified that the Class 4b pricing formula is causing an incentive to move production to one of their out-of-state plants that has the capacity to process whey.

While one cannot predict the future, there simply is no debate that the largest cheese processing plants that have been built over the last few years have been in Idaho, Texas, and New Mexico. The Panel from the June 1, 2006, Class 4a/4b hearing was concerned with this trend of out-of-state, new cheese processing construction and did not feel it was a mere coincidence because it appeared that these states afforded a better risk/reward opportunity for manufactured dairy products. The Panel continues to be concerned about the risk/reward opportunities that appear to be more favorable outside of California.

California's minimum milk price must allow processing plants to be competitive in the national marketplace. In order to be economically viable, such plants must be able to absorb the costs of the raw product (unprocessed milk), manufacturing, and their portion of transportation from the plant location to the customer in the national market. In order to remain in business, processing plants need an acceptable operating margin between the price of its manufactured product or commodity and the price of raw milk, which is its main input cost. The operating margin processors face is one of the chief economic factors providing processors with the incentive to purchase milk. The Panel recognizes that the single largest determination of whether or not California processors have reasonable operating margins is through the establishment of an appropriate MCA, which ensures that reasonable processing costs are covered.

Comparing the most recent manufacturing cost study released by the Department for the year 2006 and the current butter MCA, the weighted average cost of producing butter of $0.1373 is lower than the current butter MCA of $0.1560. When reviewing the confidential costs of the participating plants in the Department's costs study, the Panel believes the current butter MCA is adequate. When comparing the most recent cost study for the year 2006 and the current NFDM MCA, the weighted average cost of producing NFDM of $0.1664 is higher than the current NFDM MCA of $0.1600. When reviewing the confidential costs of the participating plants, the Panel believes the current NFDM MCA is too low. Also, the butter MCA is currently providing a larger operating margin compared to cheese and NFDM.

Comparing the most recent manufacturing cost study released by the Department for the year 2006 and the current cheese MCA, the weighted average cost of producing cheese of $0.1988 is higher than the current cheese MCA of $0.1780. Furthermore, when reviewing the confidential costs of the participating plants in the Department's cost study, the Panel discovered a troublesome finding that there is not a single cheese plant that has its cost covered by the current MCA, including the most efficient plants in California. Additionally, the Department's previous cost study for the year 2005 shows the weighted average cost of manufacturing cheese at $0.1914, which is significantly higher than the current MCA as well. As a result, the current cheese MCA is not providing an appropriate operating margin for cheese processors; in fact, the operating margin is actually negative. Considering the added cost to the processor associated with the dry whey factor, the operating margin appears to be inadequate, especially for smaller volume cheese processors.

Given the current MCA is not providing an adequate operating margin and given the statutory requirement that all market milk marketed in California must receive the state mandated minimum price, it is critical that the minimum Class 4a and 4b prices be established at a correct level that will "clear the market." The correct price level must ensure that California's total milk production finds a processing plant to take on the production. Failure to do so causes a price too high and will place pressure on the minimum pricing system.

As stated in the Findings and Conclusions of the Department Hearing Held October 12 and 13, 1976, Amendments Effective December 12, 1976:

> *"It is essential that the make allowance be of sufficient magnitude that processors can recover their processing costs. Otherwise, they will be unwilling to process Class 4 products. It is essential that the Class 4 price be so structured so as to clear the market. The key function of the make allowance is to facilitate the market clearing function at the Class 4 level."*

The operating margins available to processing plants are determined by the Department's establishment of the MCA in the Class 4a and 4b pricing formulas. There is limited opportunity for processors to adjust the operating margin by increasing their product prices because of the competition found in the finished product market. If processing plants were to instead reduce their operating costs, the cost reduction could be reflected as a decrease in the subsequent manufacturing cost study compiled by the Department. When the manufacturing cost declines, there is a possibility that the MCA could be lowered as a result of a future hearing, this would decrease the operating margin for the processor. The attempt to increase their operation margin by reducing costs could possibly lead to an offsetting decrease in the MCA, which would neutralize the desired outcome.

Ultimately, the Department has the responsibility and mandate to establish minimum prices that will encourage California's milk production to be marketed. By doing so, the disorderly marketing milk conditions cited above will be resolved. In order to assure orderly marketing of milk going into the future, the Class 4a and 4b prices must be established so that the market clears, or in other words, so the current supply/demand imbalance is equalized. The Panel believes that adjusting the MCA will work to equalize the current supply/demand imbalance by correcting the operating margins that processors face in the Class 4a and 4b pricing formulas.

When establishing the MCA for each commodity, the Panel must consider many different factors. First, the MCA must be set at a level that will facilitate a milk price that allows all the milk production to find a processing home, or so that the market clears. A market that clears is in the economic interest of all stakeholders in the industry because it leads to orderly marketing of milk in the state. Also, when reviewing the actual costs of individual plants in the state, the MCA should lead to an operating margin that is not so small that it does not cover the most efficient plants in the state, but is not so large that it provides excessive profits to the most efficient plants. The Panel also believes the respective operating margins for butter, NFDM, and Cheddar cheese should be in a reasonable relationship to each other. By providing a similar operating margin in the production of all the commodities, there is an economic incentive to produce all of the three commodities, thus diversifying processing in the state. Additionally, there should be a reasonable relationship in the volume covered among the commodities and a reasonable relationship among the return on investment of each commodity.

The Panel must also consider any and all relevant economic factors influencing the state. One important economic development for California is the opportunities that exist in the international markets for dairy products. California is in a position to take advantage of the increased, international demand for dairy products. Many members of the industry stressed the importance of the international market for California dairy products during the recent August 28, 2007 hearing. The Panel agrees that this market is crucial to the future of the state's dairy industry; therefore, the international market represents another factor that must be considered by the Panel when recommending an adequate MCA. In essence, the Panel takes into consideration numerous factors and combinations of factors when considering an adequate MCA.

In consideration of the above, the Panel made a thorough consideration of:

- the operating margins that the current manufacturing allowance for butter, NFDM, and Cheddar cheese provide processors,
- the operating margins that the various alternative manufacturing allowances for butter, NFDM, and cheddar cheese would provide processors of these commodities,
- the ratio of the operating margins that would be derived for the three most efficient processors of butter, NFDM and Cheddar cheese based on various manufacturing allowance options,
- the hundredweight margin that is afforded to the butter/powder operations relative to the hundredweight margin afforded to cheddar cheese operations, based on the statewide weighted processing costs and various manufacturing allowance options,
- the volume of butter, NFDM, and cheddar cheese production covered by the various manufacturing allowance options, and

- The weighted average manufacturing cost relative to various manufactured cost allowance options.

The Panel recognizes that the factors that affect the industry are dynamic and change over time. Upon reviewing current conditions and all the above listed factors, the Panel believes that the butter MCA requires no change from its current level, but both the NFDM and the Cheddar cheese MCA need to be increased in order to reach an appropriate level.

Panel Recommendations

The Panel recommends that:
- no change be made to the butter manufacturing cost allowance,
- the NFDM manufacturing cost allowance be increased to $0.1750, and
- the Cheddar cheese manufacturing cost allowance be increased to $0.2150

Summary of Panel Recommendations

Each and every public hearing involving milk pricing formulas can impact the economic interest of the Department stakeholders: dairy farmers, producer cooperative organizations, dairy processors, distributors, retailers, and consumers. The careful consideration of each pricing issue and the implementation of appropriate policy involve the impartial balancing of those competing stakeholder interests. Ultimately the Department's pricing decisions must be in the best long-term interest for California. Such policy decisions must address the fundamental economic factors that are being driven by the dynamic supply/demand forces of the domestic and international markets.

California's sustained and ever expanding milk and dairy product production, over many decades, has provided the California dairy industry with a unique opportunity to become a major supplier in the world market. It is critically important that the Department's dairy policy decisions enable the California dairy industry to take advantage of the long-term opportunities that will be afforded by the global market.

1. Plant Credits:

a. Dry Whey Credit – Should a dry whey credit be implemented through the pool?
Panel Recommendation: The Panel recommends that the dry whey credit proposal be denied.

b. Plant Capacity Credit – Should a credit from the pool for plant expansion or new plants be implemented?
Panel Recommendation: The Panel recommends that the plant processing capacity credit be denied.

c. Multi-Tier Pricing – Should different MCA in the same Class be set based on volumes produced within thresholds?
Panel Recommendation: The Panel recommends not using different MCA based on volumes that would create multi-tiered pricing in the Class 4a and 4b formulas.

2. f.o.b. California Price Adjusters – Should the price adjusters for Butter and Cheese, and the methodology used to calculate them be changed?
Panel Recommendation: The Panel recommends not making any changes to the methodology used to calculate the f.o.b. California Price Adjusters.
The Panel recommends changing the price adjusters in the Class 4a pricing formula as follows:
- Increase the butter adjuster from $ 0.0168/lb. to $0.0309/lb.
- No change be made to the f.o.b. adjuster for cheese.

3. Dry Whey Factor – Should the whey factor be eliminated from the Class 4b pricing formula?
Panel Recommendation: The Panel recommends removing the current whey factor and replacing it with a fixed whey factor of $0.10 per hundredweight.

4. Manufacturing Cost Allowances – Should any of the manufacturing cost allowances (Butter, NFDM, Cheese and Whey) be changed?
Panel Recommendation: The Panel recommends changing the manufacturing cost allowances as follows:
- Increase the manufacturing cost allowance for cheese from $ 0.1780 to $0.2150

- Increase the manufacturing cost allowance for NFDM from $0.1600 to $0.1750
- No change be made to the manufacturing cost allowance for butter.
- Since the whey factor has been replaced, the MCA is no longer relevant.

Price Effects of Panel Recommendations

Had the Panel recommendations been in effect from September 2002 to August 2007, the five-year average annual impact would have been:

• down $0.19/cwt. for Class 4a prices;
• down $0.51/cwt. for Class 4b prices; and
• down $0.32/cwt. for Quota and Overbase prices.

Note: The supply/demand conditions that existed during the 2002-2007 period may or may not be the same conditions that will occur in the future.

This Hearing Panel Report has been prepared and submitted by:

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Appendix A

SUMMARY OF PROPOSALS FOR THE OCTOBER 3, 2007 HEARING WORKSHOP — IN PREPARATION FOR THE OCTOBER 10, 2007 HEARING

Class 4a

Difference between CME & Aver. Price Received by Processors — MCA - Amt. to deduct for Processor's costs — Yield: Lbs. of butter from 1 lb. of fat

Fat = (CME Butter Price - $0.0168 - $0.1560) x 1.2

SNF = (CA NFDM Price - $0.160) X 1.0 — Yield: Lbs. of powder from 1 lb. of SNF

MCA - Amt. to deduct for Processor's costs

Class 4b

Fat = Class 4a Fat

Difference between CME & Aver. Price Received by Processors — MCA - Amt. to deduct for Processor's costs — Yield: Lbs. of cheese from cwt. of milk — Difference between CME & Aver. Price Received by Processors — MCA - Amt. to deduct for Processor's costs — Yield: Lbs. of whey butter from cwt. of milk

Product Value = (Cheddar Price - $0.0252 - $0.1780) x 10.2 + (CME Butter - $0.10 - $0.1560) x 0.27 +

MCA - Amt. to deduct for Processor's costs — Yield: Lbs. of dry whey from cwt. of milk

+ (Western Dry Whey - $0.267) x 5.8

Aver. % fat in milk for Cheddar

SNF = Product Value - (3.72 x Price of Class 4b fat) / 8.80

Aver. % SNF in milk for Cheddar

F & A DAIRY

Class 4b

Product Value = (Cheddar Price - $0.0252 - $0.1780) x 10.2 + (CME Butter - $0.10 - $0.1560) x 0.27

*Eliminate Dry Whey Factor

ALLIANCE OF WESTERN MILK PRODUCERS

Pool Plan Adjustment - See Alternative Proposal submitted by Western United Dairymen, Alliance, and Milk Producers Council

WESTERN UNITED DAIRYMEN, ALLIANCE, MILK PRODUCERS COUNCIL

Class 4b

Product Value = (Cheddar Price - $0.0252 - $0.1780) x 10.2 + (CME Butter - $0.10 - $0.1560) x 0.27
+ (Dry Whey Price - (NFDM Mk Allow + $0.0300)) x 5.8 *Snub Whey at NFDM Mk Allow + $0.0300

Pool Plan

Credit to Plants purchasing milk for Class 4b utilization for up to 264,480 solids-not-fat processed:
Credit = (Dry Whey Price - (NFDM Mk Allow + $0.0300)) x 5.8 *Snub Whey at NFDM Mk Allow + $0.0300

LAND O'LAKES

Class 4a

Fat = (CME Butter Price - $0.0280 - $0.1560) x 1.2

SNF = (CA NFDM Price - $0.1664) x 1.0

Class 4b

Product Value = (Cheddar Price - $0.0252- $0.1988) x 10.2 + (CME Butter - $0.10 - $0.1560) x 0.27
+ (Western Dry Whey - $0.2734) x 5.8

DAIRY INSTITUTE

Class 4a

Fat = (CME Butter Price - $0.0280 - $0.1560) x 1.2

SNF = (CA NFDM Price - $0.1664) x 1.0

Class 4b

Product Value = (Cheddar Price - $0.0270 - $0.1988) x 10.2 + (CME Butter - $0.10 - $0.1560) x 0.27

*Eliminate Dry Whey Factor

HUMBOLDT CREAMERY

Class 4a

Fat = For first 210,000 lbs milk fat processed: (CME Butter Price - $0.0168 - $0.2061) x 1.2
Remaining Volume Milk Fat >210,000 lbs: (CME Butter Price - $0.0168 - $0.1560) x 1.2

SNF = For the first 522,000 lbs solids-not-fat processed: (CA NFDM Price - $0.2020) x 1.0
Remaining volume solids-not-fat >522,000 lbs: (CA NFDM Price - $0.1600) x 1.0

Class 4b

Product Value = (Cheddar Price - $0.0252- $0.2104 (First 6,000,000 lbs. milk processed) / $0.1780 (Remaining >6,000,000 lbs. milk)) x 10.2
+ (CME Butter - $0.10 - $0.2061 (First 210,000 lbs. milk fat processed) / $0.1560 (Remaining >210,000 lbs. milk fat)) x 0.27
+ (Western Dry Whey - $0.267) x 5.8

CALIFORNIA DAIRIES, INC.

Class 4a

Fat = (CME Butter Price - $0.0397 - $0.1607) x 1.2

SNF = (CA NFDM Price - $0.1698) x 1.0

Plant Capacity Credit

Any plant who has constructed a processing plant or expanded an existing plant after 1/1/08 shall receive $0.50/cwt. of milk processed in the new plant and $0.50/cwt. of additional milk processed as a result of expansion of an existing plant.

Appendix B

State of California

Memorandum

To : Richard E. Rominger
Director

Date : December 14, 1982

Place : Sacramento

Phone: 5-7590

From : **Department of Food and Agriculture** – V. L. Shahbazian, Chief
Bureau of Milk Stabilization

Subject: Recommendations With Respect to Hearing Held on September 14, September 29 and November 23, 1982 to Consider Amendments to the Pooling Plan for Market Milk

Background

By action of the Legislature a permissive pooling program was set into effect on July 1, 1969. The Gonsalves Milk Pooling Act created the legal framework for what is today the California Milk Pooling program. In the initial legislative authority, direction was given to the Director of the Department of Food and Agriculture to establish a milk pooling plan for the State of California.

At the outset the Legislature was specific with respect to how pool quota was to be established and as to how future allocations of quota should be made. In effect the Legislature directed that those producers who enjoyed relatively high Class 1 usage should not be adversely affected or have their share of the Class 1 market diminished by the action of the Director. It was also recognized at that time that those producers who were not enjoying higher classes of usage would be given the first opportunity to obtain greater quota holdings as increases in Class 1 sales occurred. Producers whose assigned pool quota was 95% of their production base were considered to be at "equalization" and would, under the law, not gain additional quota as the new Class 1 usage was assigned to lower quota holders. The legislation resulted in the Director's establishing the Pooling Plan for Fluid Milk on July 1, 1969.

It was unfortunate that in the years immediately following the establishment of the Pooling Plan that increases in Class 1 sales were insufficient to bring to equalization those low quota producers who were producing at the inception of the pooling program. Assembly Bill (A.B.) 1110, passed by the Legislature in 1977, amended the original precepts on which quota was assigned, bringing all producers who were producing at the inception of the Pooling Plan up to equalization.

In both the initial legislation and in the amendment with respect to quota allocation there was no attempt on the part of the Legislature to equalize monetary returns to all producers. In 1982, an attempt was made through Senate Bill (S.B.) 1545 to more closely equalize returns to all quota holders but the bill failed, leaving existing statutes with respect to "equity" as originally established.

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The effects of establishing a quota system in which producers are guaranteed a share of the Class 1 market without respect to the usage to which their milk is utilized eliminates the incentive for each producer to seek the highest classified market available. Under such a pooling program a producer has an incentive to market milk at the location of the closest plant to his farm. The pooling concept has an inherent adverse effect on the serving of the high usage markets which are often some distance from the ranch location.

It is for this reason that the initial pooling plan established a milk movement system of plant location differentials which takes into consideration the cost of transportation from a dairy farm to a local country plant versus the cost of transportation to a more distant terminal metropolitan bottling plant. This system of plant location differentials establishes a zero or plus location number for urban milk processing plants located in deficit areas and progressively greater negative numbers for plants more distant from the terminal market. These negative numbers can be adjusted so as to reduce the value of that quota milk which is not moved to the metropolitan areas where milk is needed. This concept worked quite well at the outset of the pooling program and would continue to work well today if all milk were under quota.

Since the inception of the pooling program there have been increases in transportation costs which impact more heavily on shipments to urban areas since they are longer distance hauls. In addition there has been a pronounced increase in the supply of milk. This increase in production is in excess of assigned base production and is considered as overbase milk. In recent years, because of the high Federal Government support for Class 4 milk, the volumes of overbase milk have increased steadily to the current date. The trend toward increases of overbase milk has lowered the ratio of quota milk produced to the overbase milk produced. The effect of this change in ratio has caused frequent adjustment of the plant location differentials in order to compensate the quota milk sufficiently to allow the dairy farmer to ship the large volume of overbase milk he is currently producing without losing money.

This constant need to increase the compensation for quota milk has had the adverse effect of enhancing the value of quota. The producer located in the valley production area who acquires a contract to supply a city bottling plant has an incentive to purchase quota to cover all of his milk by quota. In other words, the current milk movement incentive system tends to increase the value of quota each time the returns to quota are increased to compensate for increases in the supply of overbase milk and for increases in transportation rates.

Handlers purchase market grade milk which is suitable for all purposes and not identifiable by its pool identification. Since pool quota milk has built in premium payments from all of the higher classified uses, handlers should not be required to subsidize the movement of milk to the plant of first receipt. The need to constantly increase the compensation for quota milk in order to provide an incentive to producers to move milk to deficit areas is of concern to the Department.

The last statewide adjustments to the location differential system were done in two steps. The first step was accomplished on September 11, 1979, the second on May 1, 1980. At that time the Department indicated that it was important to recognize that the current system was placing the burden of the cost of moving milk from ranch to plant on quota only and that this would constantly increase the value of pool quota. The effectiveness of the quota system as a mechanism for moving milk has become increasingly in doubt.

The ever increasing volume of milk in the overbase pool which must be moved along with the quota milk creates an excessive burden on the current system where only the quota portion of a shipment is compensated for moving the milk. It was recognized at that time that a review of the milk movement program within the Pooling Plan was necessary and it was hoped that it could be resolved by a broad based consensus of industry.

Actions Taken to Resolve the Milk Movement Problem

A hearing was held in Southern California on August 20, 1981. At that time petitioners for the hearing requested that there be a change in the milk movement provisions which would create a greater degree of "equity" between producers. It was alleged that producer's located in valley locations had less incentive to purchase quota since they received less money for their quota milk than those producers shipping to or who are located in urban areas.

There was considerable opposition to changing this system. Since the system is a closed one, any change benefits some and is detrimental to others. The only alternative would be to increase the price to handlers and ultimately to consumers. There is questionable benefit within the pooling program to either handlers or consumers that would warrant increasing the price to either. The benefits derived from pooling accrue principally to producers. The record of this hearing was not sufficiently conclusive for the Director to make the necessary findings to effectuate a change.

It was concluded that further discussion within the industry should take place in order that a greater degree of consensus be developed. Staff of the Department made itself available and attended all meetings to which it was invited at which representatives from all aspects of production and distribution were present. The series of meetings continued for approximately one and one-half years. A special subcommittee of ten representatives from the broader group was appointed since the larger group was too unwieldy and could not come to conclusive decisions with respect to the milk movement program. Staff of the Department continued to attend all meetings to which it was invited and acted as resource agent for whatever information was requested. Prior to any conclusion of these series of meetings, a bill (SB 1545) was introduced in the legislature, resulting in the discontinuance of the meetings without resolving either the milk movement situation or the equity problem. As mentioned earlier, this legislative attempt was not successful.

Current Situation

The Department once again received petitions to hold a hearing to resolve the milk movement and the equity problems. The hearing, which was called by the Director, was held in three segments. The first segment was held on September 14, 1982, and gave all interested parties opportunity to state their position with respect to continuing with the current location differential system in milk movement or to change to a different system of milk movement.

The second segment was held on September 29, 1982 for the purpose of giving all interested parties an opportunity to rebut positions taken in the first segment if they so desired. Between the second and third segments of the hearing the Department promulgated a proposal which was mailed to all interested parties on November 3, 1982 prior to the third segment which was held on November 23, 1982. The conclusions drawn by the Director and put forth as the proposal reflects not only the testimony presented at the current series of hearings but also discussions of the meetings held by the industry over the past two years.

Conclusions

From careful review of legislative enactments, both at the inception of the pooling program and in 1977 by AB 1110, at which time Chapter 3 was amended with respect to equalization, it is concluded that the intent of the Legislature was not to equalize all producers with respect to income. If the Legislature had intended that all producers would share equally in all usage and all markets, a system of annual rebasing would have been established. Under this system, each year all production of all producers would be assigned equally a percentage of usage based on the previous year's sales patterns.

It is concluded that as a result of the hearing there should be no attempt to resolve the "equity" problem as perceived by the petitioners. The proposed amended pooling plan should have as its first priority the movement of milk without the enhancement of quota value. A system of transportation allowances should be established which would move milk directly from dairy farms to designated areas of receipt (see Attachment A). This system should replace the current plant location differential system in its entirety. A transportation allowance system would remove the pressure presently occurring by the current location differential system to purchase pool quota.

All market milk shipped under a transportation allowance system should benefit from milk movement incentives, not just a portion of the shipment which is designated as quota. This concept removes quota milk per se from the milk movement incentives in the Pooling Plan and creates equal incentives on all milk. Under the current system quota milk has been overcompensated in order to accommodate the necessary haul of the overbase milk which must be shipped with it. All milk is the same quality from the handler use standpoint.

The transportation allowances should be based on the proximity of the dairy farm to the terminal market. Mileage brackets which reflect current milk movement and are related to current transportation costs should be established (see Attachment B). Such allowances can be adjusted over time as changes in transportation costs occur.

Milk which does not need to be attracted to the central terminal markets should be exempted from receiving transportation allowances. The system should also assure that the milk closest to the market should be attracted first.

It is important to recognize that there are basic differences between the manner in which the Northern California terminal market and the Southern California terminal market is served. In Northern California there are three terminal markets or areas which should be designated receiving areas. In Southern California there is one.

The receiving areas in the northern part of the State are served principally by ranch to plant movement which will involve considerable cost under the proposed transportation allowance system.

The major standby and "swing" supply area for the southern metropolitan region comes from a great distance located in Kings, Tulare and Fresno Counties. Current regulations allow for plant to plant movement of bulk milk from plants located in these areas into the Southern California market. There is little need to attract large volumes of milk on a ranch to plant basis. There should be very little cost in establishing a transportation allowance system for the southern part of the State.

It is for this reason that two separate sub-pools should be established for the payment of the cost of moving milk ranch to plant (see Exhibit C). The cost of paying for transportation in each sub-pool region should be charged to the quota milk produced within that region. The only exception should be that producer handlers who currently operate under one or more of the Pooling Plan exemptions should not participate in the proposed transportation allowance system.

The payment of the costs incurred by the transportation allowances which would be paid on milk that is moved into designated receiving areas should be charged against the milk which receives a premium payment. These are basically Class 1, Class 2 and Class 3 uses, all of which are within quota. It is the responsibility of quota holders to see that the need for milk for higher uses, for which they receive premiums, is satisfied.

Milk on ranches located at greater distances from the major terminal markets has less value with respect to the terminal market than that milk on ranches located closer to such terminal markets. A system of regional quota adjusters should be established which reflects this fact (see Attachment D).

The regional quota adjusters which should be established at this time should reflect the value of quota milk relative to the terminal market and should also attempt to minimize the adverse and destabilizing effects of a change from the present plant location differential structure to the ranch regional quota adjuster system.

Processing plants which are essentially involved in the manufacture of Class 4 products regardless of the location of their plant do not contribute to the premiums paid within the quota price. Producers shipping to these plants should not receive transportation allowances paid for by quota milk. Plants which qualify a producer to receive the transportation allowance should be located within a designated receiving area and should have more than 50% of the total pounds of milk processed at the plant location into products other than products classified as Class 4a or Class 4b.

Summary of Recommendations

1. Eliminate the current system of plant location differentials on quota milk as the incentive to move milk from ranches directly to processing plants.

2. Establish a transportation allowance system to provide the incentive to move market milk from dairy farms to processing plants located in designated receiving areas:

   a. base the transportation allowances on all market milk moved, regardless of quota held;
   b. Establish four designated receiving areas;
   c. Establish two separate transportation sub-pool regions to recover the transportation allowance costs of moving market milk into designated receiving areas located within each sub-pool region.

3. Establish a regional quota adjuster system at dairy farm locations.

4. Limit the use of transportation allowances to producers shipping to plants located in the designated receiving areas which have 50% or more in plant usage of products other than Class 4a or Class 4b.

Attachments

Approved [signature]

Date 12-16-82

Appendix C

SUMMARY OF TESTIMONY AND POST-HEARING BRIEFS

Bestwhey, LLC – Barry Murphy (Independent Whey Consultant)

Testimony

- The 4b whey component factor is the most critical milk pricing issue and concern facing the cheese business.
  - Those who have entered the whey business have made a substantial investment to solve environmental and disposal problems associated with whey in order to grow their business.
- Depending on company and location, disposal costs: $100-400 per load
- Financial strain on cheese companies that do not process all of its whey solids
- Eliminating whey component will create parity in the industry by and create an incentive to invest in whey processing
- Most cheese manufacturers see investing in whey plants as a way forward with cheese business expansion given the potential environmental impact of whey disposal.
- The current 4b whey component is stifling the growth of cheese industry.
- Raw whey has zero to negative value, but over the years the cheese industry has saved dairy farmers from an environmental catastrophe by "processing whey."
- Whey economies begin with more than one million lbs of whey per day, and over 80 percent of California plants do not process that much because it's a substantial investment, costing more than cheese investments.
- Only three of the 60 California cheese plants process whey. Most pay a disposal fee and in addition, the 4b component price – not fair.
- Alliance of proposal:
  - States that cheese makers' petition assumes "that whey has a net value of zero" – correct in its unprocessed form.
  - "Whey stream has returned millions of dollars annually to the pool," but at the expense of California's cheese industry – no new cheese plants.
  - "Credit for all plants on the first 100,000 of bulk milk" processed daily. This indicates that Alliance does not understand the cheese industry because a small plant processes no less than three million pounds of bulk milk daily.
  - Alliance has not done its homework – proposing price increases when cheese plants are asking for price relief.
- Land O' Lakes Proposal – the make allowance proposed doesn't come close to the recently published manufacturing costs for whey.
- His conclusion:
  - Eliminate the whey component in the price formula because it's the only way forward for an expansionary cheese industry.
  - The concept of "Producer entitlement" is inequitable since the producers do not cover whey disposal costs for over 80 percent of California's cheese makers; nor do they invest in whey assets or take capital risks, but expect to reap benefits in high markets.
  - The 4b whey component is the equivalent of being penalized for investing in a waste treatment plant for California's cheese industry, even though this industry is addressing an environmental problem.

Post-Hearing Brief-

- Mr. Barry Murphy's resume of qualifications as an expert witness submitted at the request of the hearing Panel.

Marquez Brothers International, Inc. – Jose T. Maldonado

Testimony

- Milk price levels seen today as a result of the whey component in the 4b formula are having a serious adverse effect on cheese manufacturers.
- The current formula assumes that cheese plants recover revenue from the whey equal to the midpoint of the western dry whey mostly spot price range.
  - Most cheese plants do not earn revenue from their whey operations that equal or are directly proportional to the revenue assumed in the formula.
- The whey component factor in the 4b formula significantly increases the price of milk, even though whey prices have no correlation to the CME cheddar cheese price – cheese manufacturers have no increase in revenue to offset the cost.
- Inequitable scenario – the milk producer takes no risk in plant investment, but can receive a $3 per CWT premium irrespective of whether the whey is dumped or processed; or sold at a profit or loss by the cheese maker.
- The scale of investment needed to achieve the economies necessary to market whey products competitively is enormous and well beyond the financial means of many cheese makers.
  - In the current pricing model, the milk producers are receiving profits without any associated risks.
- The current pricing formula is placing an undue economic burden on all cheese manufacturers.
- Whey is a byproduct of cheese manufacturing operations and should not be a component of the pricing formula unless milk producers are willing to invest in the processing and sale of whey.
- CDFA must protect the dairy industry and inclusion of the whey factor in 4b formula is threatening the ability of cheese manufacturers of all sizes to stay in business.

F & A Dairy with Group of Cheese Processors (F&A) – Dean Hatch

Testimony

- Has paid dairy producers and suppliers on time and with discount until recently.
- Current Class 4b milk price formula structure with its whey cost component has caused substantial losses to F&A and the results of this hearing will affect the financial viability of cheese manufacturers in California.
- Three main points:
  - Would like to solve financial hardships of both, producers and processors.
  - Class 4b formula – must create a balance of competing interests (California producers, processors, and consumers.)
  - Whey cost component must be removed from Class 4b milk formula.
- Producers and processors to work together and be given a chance to make a fair return on their investment.
- The current formula does not allow F&A to make a profit – a third of the monetary loss to date is attributable to paying the increased whey price based on the formula's 5.8 yield factor when F&A is only able to realize a 4.7 yield factor.
- Would like to consider alternative manufactured whey products with possibly better returns, but there is no incentive and no capital generated by current operation to make such an investment.

- The problem (no return on investment) is still present even when whey prices are low.
- The current method does not allow F&A to get an overage – no way to create an additional margin as the new price always becomes the price in the whey cost formula.
- Explanation for why the current why cost formula in Class 4b is a failed formula:
  - No return on investment
  - No ability to increase the margin
  - Potential for huge losses on whey product manufactured at high prices – resistance in the market to buy at the highest price or when market is falling.

Farmdale Creamery, Inc (Petitioner) – Scott Hofferber

<u>Testimony</u>

- Farmdale is a family-owned and operated facility manufacturing products such as jack and cheddar cheeses, sour cream, buttermilk and butter.
- Petition background:
  - In response to a threat of needed to shut down cheese operations, Farmdale banded together with other cheese makers and are petitioning for the elimination of the whey factor in the 4b minimum price formula.
  - The financial crisis became apparent in June when cheese makers began surfacing with the same issue; namely, the minimum regulated price was higher than what we could realize out of the markets on the finished products.
  - In order to remain viable while waiting for the emergency hearing, Farmdale had to cut back staff and processing volumes, one-week shut down of cheese making operation, plus concessions from suppliers and customers.
- The petition:
  - Removal of the whey factor from the Class 4b formula used for calculating the minimum regulated price of milk used in cheese.
  - Reiterate prior testimonials: whey is a waste product from cheese making process; whey has little value in itself except after value-added processing; various disposal avenues for whey stream have different costs and are borne solely by cheese manufacturer; hearing Panels have consistently recommended the removal of whey factor.
  - Cites article on Cheese Market News dater August 3, 2007 (attached) – "…Dry whey is a value-added product mistakenly added to a base milk price." Any value attributable to the whey stream belongs to the cheese makers who, by their own innovation and capital investment, have found a way to make something out of nothing.
  - Trees and saw dust analogy to milk and whey stream – willing to ship wet whey stream to producers.
  - Farmdale does not achieve the value in the marketplace presumed in the whey factor. Since yield is only two-and-a-half to three percent, Farmdale's cost to process the material is roughly the current make allowance $0.267.
- Some results of Farmdale's cheese making operations:
  - 2005 – Total loss of $439,000, of which $260, 000 came from selling waste whey stream.
  - 2006 – Total loss of $413,000, with $142,000 lost from processing and selling whey stream.
  - 2007 – Total loss $347,000, but gained $1,383,000 from whey processing and selling whey stream.
- Farmdale has subsidized such losses believing that that Department would regulate industry in accordance with sound economic principles applied to hard date, but no longer the case due to current crisis.

- Specialize in making block jack and Cheddar cheeses and used to compete with economies five to ten times their size until the implementation of the whey factor.
- The petition is simple – the continuing inclusion of the whey factor in the 4b formula, against the repeated recommendation of the Department's own hearing Panel experts, was a mistake that must now be corrected.
  - Remove whey factor and restore formula to its pre-2003 construct.
  - Implement this measure as a first step in maintaining the health of California's cheese industry.

Post-Hearing Brief

- In answer to Panel's question regarding milk redirection out-of-state or dumping:
  - August 10th-18th, milk was diverted to the DFA plant and based on information from co-ops management, excess milk was to be diverted to Idaho.
  - Unable to obtain clear answer regarding milk dumping since per co-op management, CDFA tracks all milk movement within and out of state.
- Farmdale was unable to reach out to producers through meetings and discussions prior to filing petition because of sudden marketplace events during the spring and summer.
  - The only common benchmark is the wet whey stream, which has no market and therefore no value to Farmdale. The only value is that which we can create for it by investment, risk taking, and market finding.
- Is there a middle ground? The best solution is to set a minimum regulated price at a truly minimal level and allow each manufacturer and supplier organization to find the unique middle ground for that specific set of circumstances through negotiation and premium setting.

Western United Dairymen (WUD) – Tiffany LaMendola

Testimony

- WUD is that largest dairy producer trade association in California representing about 1,100 dairy families.
- Testimony related to the F&A, *et al.* petition is reflective of the views of the Alliance, Milk Producers Council, and WUD. However, concluding testimony pertaining to the other alternative proposals is solely the WUD position.
- The petitioner's request to eliminate the dry whey component from the California Class 4b formula is not the correct approach because it voids the value of the whey stream for every pound of milk used to make cheese.
- According to CDFA data, in 2006, California produced 23 percent of the nation's cheese, ten percent dry whey, and 38 percent of the nation's whey protein concentrate. These figures show the magnitude of California's presence in these markets.
- The F&A *et al.* proposal would result in California Class 4b price averaging $2.32 per cwt. below FMMO Class III prices for the 2206/2007 period.
  - Even if dry whey prices remain at a moderate level of $0.4 per pound, a $0.76 per hundredweight discrepancy would be created by the removal of the dry whey component.
- Offering a compromise – specifically, a "dry whey credit" that address the small to mid-size cheese maker's concerns and provide some relief to the remainder of cheese manufacturers in the state.
- Alternative proposal – comprised of three distinct components:
  - Dry whey credit
  - Snubber on the dry whey component
  - Alternative approach to setting the dry whey manufacturing cost allowance

- Dry whey credit – The whey stream has value and should be reflected in the 4b formula; otherwise, it would undervalue milk used in cheese making and conflict with Food and Agricultural Code.
  - Dry whey is a reasonable basis for establishing a value for the whey stream in the 4b formula. If cheese manufacturers would like to incorporate other whey products into the formula (i.e. WPC), then they would have to provide the guidance and data to do so, but there is no reason to discard the value of whey.
  - Small cheese manufacturers allege they are unable to process whey and capture value from market, but mid-to-larger manufacturers likely have the economies to do so even if they chose not to.
- The aim of this proposal is to provide relief to cheese makers who cannot process whey and as listed below:
  - Credit up to 100,000 pounds of daily milk used for cheese, and about 3,040,000 per month, to be paid on solids-not-fat (SNF) basis up to 264,480 per month.
  - Credit available to all cheese manufacturers on qualified pounds as determined by the formula.
- Implementation of this proposal includes an attempt on our part to take into account both the Stabilization and the Pool Plan and is as follows:
  - Non-pool [cheese] plants that purchase milk from pool plants should be eligible for the credit provided that the value of milk purchased is captured in the pool.
  - Any non-pool plant that purchases market milk directly from a producer would not be eligible unless they decide to pool their milk.
  - Any non-pool plant that purchases Grade B milk directly from producer would not be eligible. Instead, they can negotiate price with producers and even eliminate dry why value on their own.
- If our proposed language does not accomplish our intent, we leave it to CDFA to develop the specific language.
- The “dry whey credit” would work just as the fortification allowance or transportation credits as set forth in the Stabilization (Article 9, §900(c)) and in the Pooling Plan (Article 8.1).
- Small to mid-size cheese manufacturers will essentially be exempt from paying the dry whey component as their pool credit will offset their obligation on the Class 4b price. For large manufacturers, the credit will act as an added incentive.
- Data from the Department for May, June, and July 2007 revealed a natural break in the data at 100,000 pounds of milk daily.
  - Out of 60 plants, 35 would be eligible for 100 percent of proposed credit; in effect the dry whey component would be eliminated form their price.
  - The next six would get a credit on about half of their milk.
  - An additional six plants would be eligible for credit on 15 percent of their milk.
  - The remaining 13 plants, if they are large, they would receive a smaller share of the milk credit, but will manufacture some type of whey product and receive returns from the marketplace. Or, if they are lower volume plants, then they will benefit from higher credit plus market returns for whey products they make.
  - August 2007 data released by the Department lends credibility to the credit proposal with which 42 out of the 61 plants would be eligible for 100 percent credit.
- Snubber implementation on the dry whey component of the 4b formula such that the price is never negative. Disposal costs for any non-viable whey are included as the direct disposal cost in the manufacturing cost.
  - Snubber is a necessary component to credit proposal so that a negative dry whey value does essentially become a charge.

- We suggest an alternative method for setting dry whey make allowance in which $0.03 per pound would be added to the NFDM manufacturing cost allowance.
- Concerns about the sole use of the CDFA cost study in setting the dry whey make allowance are as follows:
  - No other California product manufacturing cost exhibits such a large deviation from plants outside the state as detailed in the Cornell cost study- $0.1123 in 2006 and $0.0875 in 2005 per pound.
  - The USDA's decision to omit only the CDFA dry whey cost study from consideration can be taken as a failed vote of confidence in its validity by USDA.
  - Evidence suggests that there is less extraction of skim whey powder for the same amount of milk going into Mozzarella than there is going into Cheddar cheese production. And a lower volume of skim whey will increase the fixed and semi-variable cost components in the cost study.
- Justification for the proposed $0.03 per pound addition to the NFMD allowance:
  - In spite of lacking cost data, in January 2003 CDFA implemented a dry whey make allowance of $0.17 per pound, which was two cents higher than the NFDM manufacturing cost allowance.
  - The difference between processing costs for seven NFDM and seven dry whey plants in the Cornell study for 2006 was $0.0314 per pound.
  - Testimony and evidence provided at the January 2006 federal order hearing by national cheese manufacturers supported the addition of approximately $0.025 cents to NFDM manufacturing cost to capture the incremental cost associated with drying whey.
- Whether or not $0.03 per pound addition to the NFDM make allowance is the correct level, we propose a lower dry whey make allowance. The $0.267 per pound cost allowance is too generous, especially with the proposed dry whey credit.
- (WUD position) - Given the new cost structure imposed on California dairies, we cannot support any of the alternative proposals seeking to increase manufacturing cost allowances or f.o.b. adjusters.
- The last reductions to minimum prices shaved off about $0.20 per hundredweight from pool prices in California and put dairy families in hard economic times.
- Production costs are on a steady upward trend and do not reflect environmental mitigation and regulatory costs. At the same time, prices have been volatile and far below costs for many months.
- A review of the elements that determine producer profitability shows that milk production is the only element a producer is able to control to influence the bottom line.
  - Producers cannot set minimum regulated prices, but it's the only price they're guaranteed to receive.
  - Premiums are provided at the processor's discretion.
  - Producers have limited ability to lower production costs given the escalating costs of doing business in California, increasing feed and transportation costs, plus growing environmental regulation.
- Expanding milk production in the state may not be as easy as in the past given the environmental requirements such as the Waste Discharge Requirement (DWR) and air quality standards.
- We ask CDFA to recognize that producer prices of the past will no longer be sufficient to cover production costs posed by the new cost structure and the real cost of complying with environmental regulation in the state.
- Lowering Class 4a or 4b prices to address plant capacity concerns is inadequate. The issue needs to be handled directly, not through a transfer of assets from dairy families to processors who may or may not expand capacity in the state.

- We recognize that there is a need for better producer and processor input to deal directly with plant capacity and to develop a strategic plan for the industry – the Dairy Institute has agree to participate.
- Some of the questions and concerns our members have raised include:
  - Environmental regulation may have a chilling effect on milk production increases.
  - Current cost structure and inevitable downturn in milk prices continues to escalate consolidation of dairy farms.
  - What hurdles, beyond the regulated prices, do we need to overcome in order to do business in the state?
  - In order to bring producers to the table, and especially to ask them to help fund new capacity, they need to be fully apprised of the intentions of processing plants in the state.
- We believe that forming a committee with all industry stakeholders would be prudent and we ask that CDFA allow this effort to unfold before implementing the approach currently suggested by CDI.

Post-Hearing Brief

- Statutory authorization, "substantive" or procedural and unequal raw product costs were three issues raised by members of the Panel in regards to our dry whey credit proposal.
  - These concerns are fully addressed in the attached letter from our legal counsel.
- Proposing a credit formula as established in §300.3 of the Stabilization Plan - a divisor of 8.8 instead of 8.7, and not to exceed 264,480 pounds of SNF per month.
- It is not our intent to change or to create a second Class 4b price. Instead, the proposed language was structured to mimic that of fortification allowances in Stabilization Plan and then implemented in §900 and 901 of the Pooling Plan.
- Compared Cornell high cost dry whey plant volume to that of the representative plants in the CDFA cost study, and based on span of observations, the 2005 CDFA cost study seems to be the closest fit for comparison purposes.
  - Continue to support our assertion in our testimony that the divergence between the two studies is difficult to interpret and that due to the inevitable loss of the CDFA dry whey cost study, a different method of establishing a dry whey manufacturing cost allowance should be employed.
- Dry whey component - Testimony from California cheese manufacturers seemed to indicate 2007 losses associated with whey protein product production.
  - This is hard to understand given the tremendous demand and record prices for dairy protein products and a dry whey manufacturing cost allowance provided to California cheese makers – nearly $0.11 per pound over their competitors.
  - The only price that producers are guaranteed to receive for their milk is through the regulated minimum pricing formulas.
  - Eliminating a valued component, such as dry whey, and assuming plants will pay similar premiums in its absence in the formulas, is unsupported.
- Industry compromise – We put together a compromise to offer a dry whey credit to those plants that argue they truly do not have the ability to process their whey stream.
  - Efforts to work towards a compromise did extend beyond Alliance, MPC, and WUD – contacted a major independent processing representative as well as an additional California cooperative.
- Plant capacity – We have invited the Dairy Institute of California to work with us to establish an industry committee to deal directly with plant capacity and develop a strategic plan.

- A reduction in class prices in order to provide incentives for plant capacity would put the Department in a position of setting policy – a role that is properly filled by industry stakeholders.

- Letter from WUD legal counsel, Mr. Vlahos and Ms. Johnson of Hanson, Bridgett, Marcus & Vlahos, LLP and are summarized below:
  - The proposal involves only a procedural amendment to the Pooling Plan, maintains a uniform Class 4b price, and does not create prohibited unequal raw product costs.
  - The Stabilization and Marketing Act is intended as a guideline and it empowers the Secretary to adopt plan provisions that promote the purposes of the statute and are consistent with the policy guidelines set forth therein.
  - However, should a specific statutory authorization be required for the proposed dry whey credit, it can be found in §62076(a).
  - The proposed credit directly relates to the Secretary's mandate to consider the relative market value of products yielded from milk because it accounts for the cheese manufacturers that are more likely to yield additional products from their whey stream.
- The dry whey credit is a procedure for continuing to recognize the value of milk which may be used to produce whey products.
  - Disagrees with testimony from the Dairy Institute of California dated October 9, 2007, arguing that the change proposed to the Pooling Plan was substantive.
  - The proposal does not add a new element to either the Stabilization & Marketing Plan or the Pooling Plan, but seeks to preserve value that is already recognized by the existing pricing system.
  - Unlike the petition which seeks to deprive producers of the full value of their milk, the dry whey credit is a procedure for preserving much, if not all, of that value for the benefit of the producers.
- The proposal maintains a uniform class 4b price and does not create prohibited unequal raw product costs.
  - The dry whey credit is uniform, as it is available to all cheese manufacturers on the qualified pounds.
  - The proposed dry whey credit complies with the relevant code section regarding uniformity of costs in the Stabilization & Marketing Act, Food & Agricultural Code §61808 (d).
  - The pricing provision most relevant here is §62706 that requires the director to "take into consideration any relevant economic factors."
  - The proposal recognizes the existence of different conditions for processors of different sizes, every processor is treated the same by each volume of milk processed.
- The argument that credits which result in variations in processors' ultimate costs violate the equal raw product rule would invalidate similar credits, such as "make" allowances, which only approximate, but do not equal every processor's actual manufacturing costs.

Humboldt Creamery – Rich Ghilarducci

<u>Testimony</u>

- Humboldt Creamery processes and markets Powdered Milk, Ice Cream, and Fluid Milk Products.
- Manufacturers are looking to the Department to solve the inequity of their revenue to expenses.
  - Current raw product prices are a reflection of supply and demand and not the State of California milk pricing system.
- Alternative proposal maintains parity between the California classes of milk and allows for the dairy industry to remain regionally diverse.

- Based on the current pricing system, the California dairy industry will eventually be consolidated to a few counties since milk production volume dictates a manufacturing plant's ability to achieve production efficiencies.
- Our proposal uses the same milk volume thresholds for class 4a and 4b processors and incorporates the State audited cost to calculate the difference in manufacturing allowances between small and large manufacturers.

- Manufacturing allowances - Based on the State of California audited weighted average manufacturing cost study, four out of eight plants are classified in the high cost group and are losing about $0.04 cents per lb. on the 100 million lbs of powder they process annually.
  - We believe that make allowances should be adjusted to the published cost studies, while also addressing the difference between small and large manufacturers.
  - The State of California needs to alter the return on investment calculation and ensure we maintain the facilities already established within the State.
  - The return on investment calculation should be calculated using the replacement value of the plant assets multiplied by the rate on a ten-year note, which would be a closer reflection of the value required to maintain or build new facilities.
- Class 4b price structure – Humboldt supports maintaining the whey component in the 4b pricing structure.
  - California manufacturers should have an adequate manufacturing allowance and should be rewarded for innovative marketing.
  - Processors should not be allowed to prosper by not paying the true value for the milk they are processing
  - This alternative proposal addresses the inequity in the current 4b pricing structure which is the difference in plant size, not whether there is a value to whey.
  - The proposal addresses the inequities within the California Milk Stabilization Plans related to small manufacturers as well as maintaining parity between Class 4a and 4b pricing structure.
- Humboldt Creamery supports the adjustment in make allowance as proposed by California Dairies.

Land O'Lakes (LOL) – Tom Wegner

<u>Testimony</u>

- LOL members own and operate several cheese, butter-powder and value-added plants in the Upper Midwest, East and California.
- Believes the Department needs to make changes to the Class 4a and 4b formulas to encourage investment in the development of additional manufacturing capacity in the state.
- In support of our alternative proposal filed with the Department involving the make allowances and/or price adjusters for butter, NFDM, cheese and whey.
- LOL recommends that the Department maintain the current butter make allowance of 15.6 cents per pound in the 4a formula.
  - For the butter price adjuster, we recommend the simple difference between the Chicago Mercantile Exchange butter price and the prices received by California processors for twelve months ending August 2007.
- For NFDM, recommends that the make allowance be increased from the current 16 cents per pound to 16.64 cents.

- Recommends the Department increase the cheese make allowance from 17.8 cents to 19.88 cents reflecting the weighted average manufacturing cost for cheese from the most recent CDFA cost survey.
  - Recommends no change in the FOB price adjuster for cheese.
- We recommend that the dry whey make allowance be based upon the difference between the current dry whey make allowance and the current make allowance for NFDM.
- Recommends that the Department use the difference that currently exists between the make allowances for dry whey and NFDM amounting to 10.7 cents per pound, and apply that difference to the recommended make allowance for NFDM of 16.64 cents.
- Specific changes and proposed language to the Northern and Southern California Stabilization Plan, Article III, §300.0 (d) The minimum prices to be paid for components for Class 4a, and (e) the minimum prices to be paid for components used for Class 4b.
- LOL feels that covering roughly 60 percent of butter processed with the current make allowance of 15.6 cents is adequate and consistent with previous Departmental decisions.
- Increasing the NFDM make allowance will increase the volume coverage to a more acceptable level that is consistent with previous Departmental decisions.
- LOL recommends that the Department set the cheese make allowance at 19.88 cents to improve the ROI from operating a cheese plant.
- Under the current dry whey make allowance of 26.7 cents, the approximate return on investment for dry whey powder plants was less than 4.05 percent.
- The updated make allowances should provide some immediate and much needed financial relief to all cheese plants regardless of size.
- Perhaps the Department may want to consider using the percentage increase in NFDM processing costs or a form of indexing to update the whey make allowance.
- Our current proposal would add 10.7 cents to the powder make allowance to arrive at a make allowance for whey.
  - If our proposal were adopted, as a result of future hearings, the absolute difference between the powder and the whey make allowance would become larger as time goes on.
- California's milk production has been increasing rapidly in 2007.
  - On a daily basis, this increase amounts to about five million pounds [of milk] per day which nearly equals the initial capacity of the new CDI plant.
- There has been a loss of cheese plant capacity – capacity lost amounts to 168 loads per day or about 8.5 million pounds of milk per day.
  - Any additional loss in plant capacity would put even more stress on the milk processing sector.
  - Very possible in light of the recent default of the F&A cheese plant that receives 30 loads per day.
- The impact of the inadequacy of the cheese make allowance has already been realized in the decisions by both Glanbia and Hilmar to build new cheese plants outside of California.
  - These two plants would have provided California with badly needed manufacturing capacity.
- Do not support the CDI proposal to implement a plant processing capacity credit.
- Using the market wide pool to finance the expansion or construction of an individual cooperative's or proprietor's plant is not equitable, especially to those producers who would not have access to the expanded or new plant.
- LOL does not support the DI proposal to increase the FOB cheese price adjuster to 2.7 cents.
- Does not support Humboldt Creamery alternative proposals to increase the make allowances above levels that are cost justified by the weighted costs collected by the Department.
  - Oppose multi-tiered approach to the make allowances issue.

- Additionally, the Humboldt and CDI proposals may violate the food and Agricultural Code §61805(b).
- Advocate the adoption of the LOL proposal for make allowance and price adjusters for butter and powder.
- The returns on investment for cheese and for butter-powder operations should be very similar and both need to be adequate based on economic factors within the marketplace.
- The proposal by LOL is a reasonable one for producers and for manufacturing plants.
- If long-term returns to producers' investments in cheese plants do not improve, more cheese plants do not improve, more cheese may cease operations putting even more stress on the remaining plants.

Post-Hearing Brief

- LOL handled distress milk during this year's flush season
  - In early May, LOL purchased up to five loads per day from a large cheese processor.
- The availability of milk in California may be a sign that the manufacturing allowances, especially for cheese, may be inadequate.
- Handlers are required to pay minimum class prices for in-plant uses whether such handlers are operating pool or non-pool plants (§62078).
  - The code does not allow plants to pay producers of market milk less than the minimum class price according to use even though such milk is considered distress milk.
- Furthermore, a handler purchasing distress milk at class prices is exposes that handler to the risk of inventory devaluation stemming from falling commodity prices.
- In contrast, handlers regulated in Federal order markets or handlers operating in unregulated areas can purchase this same California distress milk at substantial discounts and are practically guaranteed a profit.
- LOL realizes that custom processing is another option of how to handle distress milk – normally limited to Class 4a products.
- To custom process another handler's milk, a processor typically incurs additional handling and accounting costs necessary to properly record and report milk volumes processed to the CDFA.
- Perhaps the burden of additional handling and accounting for custom processed products is why custom processing of distress milk does not occur more often.
- LOL suggests that the Department establish make allowances that result in a return on investment of eight to ten percent on the original equipment cost to adequately cover the risk premium of investing in manufacturing commodity dairy products.
- LOL urges the Department to consider the need to balance the producer benefits from rising whey prices against the costs of rising whey prices to cheese processors.
  - Whey clearly has value in the market, but we need a realistic and balanced approach to approximating that value in the 4b pricing formula.
- Agrees that convening industry meetings may be a good way to develop proposals that would strike a compromise between processors and producers.

Dairy Institute of California (Institute) – William Schiek

Testimony

- The Institute is a trade association representing 34 dairy companies which process approximately 75 percent of the state's fluid milk and manufacture about 75 percent of the state's cheese.
- The regulated price for milk used in manufactured products, particularly cheese, is too high.

- Milk output growth is accelerating, but dairy manufacturing plant capacity has not been keeping up.
- More cheese plant capacity is at risk for loss due to a milk cost/cheese revenue squeeze that has been induced by the whey factor in the Class 4b formula.

- The level of regulated price plays a key role in maintaining an orderly market.
- When regulated prices are set too high (or more specifically, when there is not enough of a wedge between the manufactured product price and the milk price), manufacturing plants have no ability to create the margin they need to operate successfully.
  - If they increase finished product prices to customers, these are in turn reflected in higher commodity prices that are then translated through the markets and the product formula into even higher raw milk prices.
- Regulated prices that are too high also artificially stimulate milk production, at least initially, while at the same time the formula's inadequate plant margins reduce the incentive for plants to procure milk.
- Milk supply growth in California has been nothing short of astounding over the past few decades.
  - In 2007, milk output in California is running at 5 million pounds per day more than the comparable period last year.
- Based on 2007 reports in Dairy Market News, it would appear that the current processing capacity in the state (under ideal conditions) is no greater than 112 million pounds per day.
- According to USDA, California milk cow numbers grew at an average rate of 2,600 cows per month during the first five months of the year.
  - Consider that the U.S.-Canada border will soon be open to dairy cattle and heifer shipments.
- The prospect of two or three cheese plants who each use around one million pounds of milk or more per day exiting the industry makes the situation more brutal.
  - This is processing capacity that the industry cannot afford to lose.
- Public policy decisions must be based on the stark reality of California milk output growth.
- Existing California plant capacity has been placed at risk this year because of high regulated prices that do not provide adequate operating margins for many of the state's current cheese plants.
- After initially growing strongly during the first part of the year, cheese output growth retreated as the run-up in the dry whey markets drove milk costs to increase faster than revenue from cheese sales.
  - Now another adjustment to the regulated price level is needed.
- Quoted Secretary's statement regarding last year's 4a/4b hearing decision (August 2006 CEQA Initial Study, page 8).
- Rather than "eliminating economic waste," the current 4b formula is creating economic waste.
  - Milk that could be processed in California, if plants were allowed adequate operating margins, is being shipped out-of-state.
- Lowering the regulated price is the most efficient and correct way to send appropriate signals to the market.
  - It will send a signal to all producers to reduce production.
  - Most equitable way to deal with the overproduction/plant capacity problem.
- The majority of cheese plants in the state do not earn the revenues assumed in the formula.
- For plants making whey products other than dry whey, revenues have often not kept pace with the dry-whey-driven increases in milk cost.
- Smaller cheese plants that make specialty cheeses do not have the economies necessary to market whey products competitively.
- Increasing the price that they charge for cheese is not a workable solution to the specialty cheese makers' whey related problem.

- As there is no uniformity of whey operations, any attempt by the Department to select a whey product or combination of these to represent the entire California cheese industry's whey operations will virtually guarantee that some cheese makers will be unprofitable.
- The demand for milk is a derived demand, and the underlying market value of milk will be influenced by the price of finished dairy products, but other factors such as marketing costs for finished products and manufacturing costs.
  - Plant capacity will set an upper bound on the demand for milk in a given area and limit its market value, even when product prices are escalating.
- When the formula overvalues the milk, milk production is stimulated, but plants find their margins squeezed and their financial viability threatened.
- The Department's expert Panel recognized the problems with the 2003 decision and recommended the elimination of the skim whey factor.
  - Unfortunately, the Secretary did not adopt the Panel's recommendation.
- Urge the Department to remove the skim whey factor from the formula before situation becomes irreparable.
  - If cheese plants exit the industry due to poor economics imposed on them by the 4b formula construction, it is unlikely that they will return, even after the problematic portions of the formula are corrected.
- Product values should reflect the prices received by California manufacturers for their products.
  - Butter and cheese values should be based on CME prices (for butter and cheese) adjusted to reflect prices actually received by California processors.
- Make allowances should be set on a consistent basis for butter, powder and cheddar cheese based on the most recent CDFA cost studies, updated with the most recent factor cost information available.
- In the summary of the 2006 cost study, CDFA notes that for cheese, zero percent is processed at a cost less than the current make allowances of $0.178 per pound.
- The variance of costs among plants should be considered in setting make allowances.
  - The Department's ROI analysis illustrates this point, although we would prefer to see the analysis based on original cost of the plants assets, rather than the depreciated asset value.
- The Institute recommends leaving the make allowance for butter at its current level.
  - For cheese and NFDM, recommends increasing the make allowance to the new weighted average manufacturing cost level.
  - Caveat is that CDFA should set make allowances so that there is comparable volume coverage in both cheese and butter/powder.
- Proposes that CDFA abandon the 24 month average price difference and adopt the calculated average price difference from 2001 (the earliest continuous data available) through the most current time period available as the basis for establishing the f.o.b. adjusters. (Appendix A in submitted testimony).
- Institute's views on LOL proposal is that it moves the regulated 4b price in the right direction, but does not provide incentive for plant investment.
- The Alliance et al petition/proposal would provide potential relief to only the smallest plants and would raise the overall 4b price, but creates different raw product costs for the same class of milk users.
  - The multi-tier pricing would also distort the economics of the industry, and could create a disincentive for plants to grow.
  - The proposed Alliance et al pool credit would require a referendum of producers, which means that there is no guarantee that the "solution" would be adopted (for legal analysis see Appendix B in testimony).
  - The Alliance proposes a new way to calculate dry whey make allowance, but this would curtail plant capacity rather than expand it.

- Does not support the CDI proposed new plant credit plant because it has many of the same drawbacks as that of the Alliance et al in that it complicates the pricing structure.
- Does not support Humboldt's proposal because it also creates different raw product costs for the same class of milk users (Food and Ag Code § 61805(b)) and its multi-tier structure would exacerbate industry economics like Alliance *et al.*
- The most efficient way to address the current problems facing the industry is adoption of the petitioner's request to remove dry whey and adoption of the Institute's suggested changes to make allowances and f.o.b. adjusters.

Post-Hearing Brief

- Institute enclosed supporting documentation on its assertion regarding the oversupply of milk:
  - Attachment I - Dairy Market News (USDA)
  - Attachment II – California Milk Handling Situation, Summarized from Dairy Market News.
  - Attachment III – Letter from Nestle
  - Attachment IV – Knox, Lemmon, and Anapolsky, LLP
- In response to the question regarding an acceptable compromise on dry whey, the Institute believes that the relative merits of the proposals must be evaluated, and the Secretary's decision must be based on the proposal that most adequately addresses the economic factors found in the statute.
- The net outcome for the industry, had the dry whey not been in the formula since 2003, is that the market would be in balance.
- Elimination of the dry whey factor in 2007 would have had the same result as a drop in the average milk price of about 4.6 percent, and would send a much needed signal to dairymen to curtail production.
- The legislature has required the Secretary to examine whether there is adequate plant capacity as it is one of the most relevant economic factors to be considered in establishing the pricing formulas of the various classes of milk.
- Adoption of the cheese maker petition or of the Institute alternative proposal will send a clear signal that the Department is prepared to take the steps necessary to ensure that cheese makers investing in California will be able to make a return that will justify the scale of the investment they will be required to make.
- Our analysis of the statutes contained in the California Food and Agricultural Code lead us to conclude that the pool credits proposed by the Alliance *et al.* and California Dairies Inc. (CDI) are not authorized by the legislature and their adoption would violate the law (see Attachment IV).
- Cites excerpts from Food and Agriculture Code §61805(b), 62720, 62723(a), and 61826.
- Absent any other statutory directive from the legislature, any pooling plan or pricing formula that would result in unequal raw product costs to competing handlers (other than in the case of producer handlers) would violate state law.

California Dairies, Inc. (CDI) – Eric Erba

Testimony

- CDI is a full service milk processing cooperative producing 42 percent of the milk produced in California.
- Proposing a new and targeted mechanism that uses pool revenues to create an incentive for companies to construct new plants or expand existing plants.
  - The state cannot afford to lose any of its processing capacity and must make a significant and concerted effort to attract more processing capacity to the state.

- The manufacturing cost allowances should be consistent with actual costs for processing, and the butter commodity price should be adjusted by a factor that reflects what California plants actually receive for the products they produce.
  - Changes in the Class 4a make allowances that are not cost-justified would reduce producer-owner net income.
- CDI proposes that the Department increase the butter and NFDM manufacturing cost allowances to the weighted average costs incurred by CDI plants in 2006.
  - CDI plants are representative of what it costs to produce butter and nonfat powder, and these are the costs that ought to be the basis for setting the manufacturing cost allowance in the Class 4a pricing formula.
- The Department's cost updates that were conducted in the past underscored the point that when there are significant changes in major plant cost categories, they are relevant and should be considered in the process of adjusting pricing formulas.
- Selecting a manufacturing cost allowance using percent of volume covered as a guide is at issue because it has a built-in circularity to it.
  - Considering the current state of milk production and the lack of available processing capacity in the state, the Panel may want to consider eliminating from the decision making process any implicit constraints on volume of product covered by the manufacturing cost allowances.
- Would like to see the same level of investigation and review applied to manufacturing cost allowances, applied to f.o.b. adjusters as well.
- The Department needs to recognize and capture the variations in pounds of product actually sold in each month in calculating f.o.b. adjuster.
- Increasing the manufacturing cost allowance does not assure that the money diverted from dairy producers to milk processors will be used to increase plant capacity in the state.
- CDI proposes that an incentive be given to plants that add processing capacity to the state, either through a new facility or an expansion of an existing facility.
  - The credit would not apply to a plant that simply processes more milk without changing its structure or equipment.
- Proposes a credit of $0.50 per cwt. that will be available to eligible plants for a period of three years starting on the first day milk is processed by the facility.
  - Bankers will be more apt to consider financing a plant or a plant expansion if the processing capacity incentive is available well beyond one year.
- The mechanics of the plant capacity incentive would be similar to that used by the Milk Pooling Branch transportation credit and it would be in the form of a credit to the plant's pool obligation.
- Proposes a two-step approach to ascertaining the eligibility of plants:
  - Determine baseline for volume of milk handled
  - Verification by Manufacturing Cost Unit staff in Milk Pooling Branch.
- Urges the Department to adopt CDI proposal and insert the enabling language in the Stabilization Plans and Pooling Plan as soon as possible.

<u>CDI Testimony</u> – Joe Heffington

- Concerned that Return on Investment (ROI) factor released by the Department (Attached in testimony as Exhibits A and B) is misleading as an indication of profitability and is likely to be misunderstood by industry stakeholders.
  - The industry has not had the opportunity to understand the logic behind the calculations and possible ramifications.
  - Panel Report from 2006 indicated that the Make Allowance was benchmarked based on this new ROI calculation (with little or no input from the industry.)
  - Using depreciated values based on historic cost, as is the Department's practice, is not the best benchmark.

- ROI analysis (Exhibit B) would be very misleading if one product segment with older more fully depreciated assets were compared to another with newer more recently constructed assets.
- Butter and powder plants should be evaluated together, just as cheese and whey.
- No consideration given to leased assets.

- The current ROI factor should remain "just a factor" to be included in the measuring cost studies and not serve as a measure of profitability for dairy manufacturing cost comparison purposes.

Post-Hearing Brief

- Opposes Institute f.o.b. price adjuster proposal and urges the Department to adopt the results from applying the CDI proposal method to the Department's data.
- The plant capacity credit is not contradictory to §61805(b) because it permits differences in raw product costs among handlers within the same marketing area.
- Upon review of the Code §62074.5, 62077, and 62707(h), CDI is satisfied that no specific authorization is required to implement and administer a plant capacity incentive program.
- The Secretary many adopt provisions that effectuate the purposes of the statutes and that are consistent with Department policy.
- General statutory authorization is provided in §61805(d), which states the purpose of the chapter.

Imperial Valley Cheese – Dolores Wheeler

Testimony

- Supports the removal of the dry whey factor from the Class 4b pricing formula as described in the petition filed by F&A.
- Imperial Valley Cheese is a small cheese plant unable to recover the multi-million dollar investment required to install whey drying equipment.
  - Currently providing the liquid whey to a local farmer at no return.
  - If whey factor remains, it will provide additional incentive to move cheese making operations outside of California.

Post-Hearing Brief

- The by-product for a cheese maker is the whey that is left over after cheese is made. Some plants dispose it while others sell it for additional revenue.
- Dairy farmers have manure as a by product and some choose to pay to have it disposed of, while others process it for additional revenue.
- A whey component has no place in determining the "minimum" price a cheese maker should pay for milk to make cheese.
- Imperial Valley Cheese is operating at the lowest minimum milk volumes our milk contract will allow and will remain that way until price relief is in site.
- Does not support the Alliance et al proposal because it requires a plant to be part of the pool to receive the credit.
- Intrigued by the CDI proposal, but unable to fully evaluate its impact on the dairy industry due to insufficient information.
- Opposes the proposals by LOL and Humboldt because the whey component is left in the Class 4b formula.
- Supports F&A proposal and the alternative proposal submitted by the Institute.

Hilmar Cheese Company, Inc. (HCC) – John Jeter

Testimony

- HCC believes in low regulated prices and high market driven prices that allow both milk producers and processors the opportunity to remain viable.
- Supports the Institute proposal to eliminate the whey factor and update the cost factors in the 4a and 4b pricing formulas.
- While the U.S. is experiencing great dairy demand, California is struggling to process the surplus milk supply to fill that demand.
  - Surplus milk is going on the ground or being shipped out-of-state.
- The U.S. is in the best position to be the supplier of many new global markets, if we remove the existing barriers to innovation and trade imbedded in our pricing and support system and strengthen our competitive advantage.
- Supports DIC (Institute) proposal – elimination of the whey factor.
  - Believes that the current dairy system no longer fits industry dynamics because it is based on product-driven formulas that do not reflect true market realities.
  - The regulated system does not create revenue, but rather redistributes income by increasing the costs for some processors and sharing that income with everyone.
  - No incentive to innovate when any return on investment is redirected into the pool.
- Success in the whey business is critical to the survival of any mid-size to large cheese plant.
  - The whey factor has increased the milk price to the extent that milk does not clear the market and it does not allow market signals to work and allocate milk and capacity efficiently.
- In California, a coop receives the same protection as a 100 cow dairy – this adds another layer of regulation that does not exist in Federal Orders.
  - The regulated price should decrease in order to clear the market, and let market based prices be paid.
- The answer is not to further complicate the system or provide subsidies to processors, but rather to shed a layer of crippling complexity by removing the whey factor from the 4b formula.
- Despite extensive investments in our whey operations and exceptional market conditions, the regulated price has caused a loss.
- The solution is not found in many of the alternative proposals, which introduce more regulation through added classes and credits based on the size of the processor and when plants are built – essentially increase the level of regulation.
- Today, the butter/powder industry is the only area increasing processing capacity because that's what the payment system encourages.
- Cooperatives are investing in more of the same – there is no push to expand the margins through the creation and marketing of new products.
  - The focus is on the use of the system vs. innovation.
  - Excerpt from San Francisco Chronicle article – *Federal bill helps huge farmers, not California's innovative ones* by Carolyn Lochhead.
  - The current proposal to have the pool (dairymen in total) subsidize new plant capacity is another example of a massive coop trying to minimize risk by setting up more classes of prices for milk with more regulations and intervention.
- Removal of the whey factor would cause an average drop in the 4b price of $0.25/cwt.
  - Without significant change, the cheese industry in California will diminish while the powder industry will grow with its dependence on Fonterra as the exporter, making the pool less attractive in the long run.
- Current state make allowances need to be updated.
- HCC urges the Department to recommend the removal of the whey factor.

Post-Hearing Brief

- The current high regulated 4b price has created a very disorderly marketing situation of raw milk in California.
- The "compromise" that the Panel continually asked about during the hearing is to eliminate the whey factor so that cheese plants and their suppliers can negotiate market-based premiums that go directly to those supplying the cheese plants – be they individual producers or co-ops.
  - Let the market establish market clearing prices for milk – DIC (Institute) proposal must be enacted.
- Included two graphs. The first depicts the amounts that HCC Market Basket payment has been either over or under the regulated 4b price for the last 33 months. And the second shows what it would have looked like had the DIC (Institute) proposal been in effect.
- CDFA must lower the regulated price to let the market work with appropriate economic signals and to send that CDFA is not the end all in establishing milk prices.
- Attachments:
  - Excerpts showing comments on oversupply of spot milk in California.
  - Cheese Market News article dated 10/12/07.

Joseph Gallo Farms (Gallo) – Joe E. Paris

Testimony

- Supports Institute proposal because the greatest challenge facing milk producers today in California is insufficient plant capacity and this proposal will adequately address this.
- Strongly oppose Alliance et al proposal because this proposal is discriminatory and will open CDFA to legal action if adopted.
  - Alliance et al proposal would distribute credit through the pool but many cheese plants in California are non-pool plants.
- Oppose Humboldt Creamery and LOL proposals.
- Do not take a position on F&A and CDI proposals.
- Urge the Panel to recommend to the Secretary to adopt the proposal submitted by the Institute and reject all others.

Post-Hearing Brief

- Strongly supports the petition submitted by the Institute.
  - Took no position on the F&A proposal at the hearing, but would like to support their proposal in this brief if the Department rejects the Institute's.
  - No position on CDI.
- Strongly opposes proposal by Alliance et al, nor the alternative proposal of Humboldt Creamery or LOL.
- Although Joseph Gallo Farms produces whey protein isolate, the input cost of milk through the 4b price left Gallo $2.00 cwt. short in being able to recoup costs through the marketing of cheese products.
- Due to the huge milk supply in California and the lack of increased processing capacity, we have been forced to shop milk into Arizona and the price received for the milk was below the FO Class IV price.
- If the whey price is removed from the 4b formula, cooperatives can negotiate extra premiums form the processor based on the value of whey.
- In June 2006 4b hearing, LOL submitted an alternative proposal that might be a good compromise at this time.

California Dairy Campaign (CDC) – Kevin Abernathy

Testimony

- CDC is opposed tot eh petition submitted by F&A and a group of other California cheese processors to remove the dry whey factor from the Class 4 b formula.
- Cites a 2003 study by USDA Economic Research Service titled "Concentration and Structural Change in Dairy Processing and Manufacturing" stating that whey has value.
- Attachment I – chart showing amount that processors received for the whey value compared to that received by producers.
- No real repercussions for a processor when it is placed on the ineligible list, while there are real impacts to producers who are unable to sustain their operations without income from their milk sales.
- Strongly disagree with the claim that cheese manufacturers do not realize the full revenue attributed to them in the 4b formula.
- Believes that the 4b formula should be based on current market demand and prevailing market prices.
  - Processors have realized the profitability of mozzarella cheese at the expense of dairy farmers.
- Contends that the current state of the dairy industry is similar to that in the 1930's when a small number of processors controlled milk price negotiations.
- Cites a report published by the General Accounting Office (GAO) in June of this year regarding the spot cheese market and other questions about possible price manipulations.
- In our system today, large processors are able to manipulate our market to keep producer prices artificially low.
- Opposes any petitions that would lower the 4b price paid to producers; producers should be compensated in the 4b formula for dry whey because it holds considerable value in the market.
- Supports proposal put forward by the Alliance et al calling for CDFA to implement a snubber on the dry whey component of the Class 4b formula.
- Opposes Institute, LOL, CDI, and Humboldt because all would lower producer prices.

Post-Hearing Brief – Joe Augusto

- Oppose the proposals put forth by F&A Dairy, Institute, and other dairy processors that seek to eliminate the whey value in the 4b formula and make changes to the 4a and 4b formulas that would result in lower prices.
- Believes that dairy producers are banding together to give the false impression they are losing money, but no concrete evidence of their current financial situation is available.
- The ongoing plant expansions indicate that the current make allowance rate is sufficient to foster plant expansion throughout the sate.
- CDC strongly supports an industry meeting between producers and processors as proposed by members of the CDFA Panel.
- As CDFA works to make a fair and equitable decision to all parties, it should fully consider the significant dollars of profit that are coming from they whey stream.
  - Cites the new patent given to Kraft Foods Holdings, Inc. recently as a result of their shelf stable shredded cheese.

Milk Producers Council (MPC) – Robert Vandenheuvel

Testimony

- Opposes petitioner proposal to eliminate a positive value for the whey solids portion of the formula of the Class 4b formula.
  - Believes that specialty cheese makers can capitalize on that specialty product and recover a higher market value than the 40 pound Cheddar cheese block.
- MPC believes that producers are entitled to a share of the value derived from whey solids.
- Asserts that §62062 and 62076 of the Food and Agriculture Code require that producers receive a share of the value earned on the milk they produce.
- In an effort to offer a compromise that would address the small cheese makers' concerns, MPC collaborated closely with producer colleagues and developed a unified proposal to establish a credit against the class 4b pool obligation for every pooled plant in California.
  - In exchange, seeks a "snubber" that will prevent the whey solids value for producers from becoming negative and a whey solids make allowance that is more reflective of national norms with regards to the cost of drying whey.
- Attached is a copy of the testimony on "Cost of Processing in Cheese, Whey, Butter and Nonfat Dry Milk Plants" presented at the Federal Milk Marketing Order (FMMO) Hearing by Dr. Mark W. Stephenson.
- MPC believes that part of the reason CDFA adopted such a generous make allowance is to act as an incentive to expand cheese plant capacity in California.
- Minimum producer price reductions, applied across the board, are not an efficient way to incentivize new plant capacity.
- MPC is willing to support CDI proposal in exchange for a continuance of a whey solids value in the 4b formula coupled with a reduced whey make allowance.
- MPC views CDI proposal as a way for the Department to address the issue of plant capacity without significantly diminishing producer income.
- Opposes Humboldt proposal because producers should not be asked to subsidize small commodity butter, powder, and cheese plants.
- Regarding the proposal submitted by the Institute, LOL, and CDI for make allowances, MPC does not object to modest, cost justified adjustments to these factors as long as they are consistent with the alternative proposal MPC has made.
- MPC reminds the Department that their proposal to change the product value in the Class 4a formula to the Mostly Western NFDM Price as reported in the Dairy Market News.
- MPC believes that California can non longer take on the responsibility to find a California home for every gallon of milk any California producer wants to produce.
- MPC urges the Secretary to adopt their proposal.

Post-Hearing Brief

- Provides an excerpt of the testimony given by lead witness for the Institute.
- At a time when the dairy industry is reaching out to cheese manufacturers to develop a good-faith compromise on the whey issue, the combative tone from the cheese manufacturers' lead witness brings us no closer to providing a long-term solution.
- The compromise brought by MPC (Alliance et al), represents the largest concession offered by either producers or processors since a whey factor was included in the Class 4b in 2003.
  - With the last two hearing Panels recommending a full removal of whey from the formula, these processors feel no incentive to work with producers and find a middle ground at this time.

- The MPC (Alliance et al) proposal offers the compromise that would directly address the issue brought forth by the petitioners who argued that small processors with no ability to adequately process their whey stream and capture that value from the market.
- In response to Mr. Gossard's request for the sizes of plants surveyed in both the 2006 and 2007 analyses conducted by Cornell, MPC has provided a small excerpt.
- As a policy, make allowances should reflect normal costs, and incentives for new palnt capacity should be targeted and transparent.

Mozzarella Fresca – Jay Wilverding (on behalf of Andrew Branagh)

Testimony

- Mozzarella Fresca is no longer able to invest in an aggressive sales program or re-invest in our manufacturing base.
- The California dairy industry's most pressing problem is too much milk.
- Mozzarella Fresca was slotted to invest in their Tipton plant, but due to the present California milk pricing system, we have undertaken a comprehensive cost benefit study to determine if the capital investment at Tipton should be deployed elsewhere.
  - If a more favorable milk pricing formula decision is made as a result of this hearing, we will be encouraged to move forward with the planned Tipton plant expansion, thereby keeping the plant a viable investment for Groupe Lactalis and creating jobs in California.
- The capital required to install a dryer is tremendous and in order to make such a large investment economical, a certain scale of volume must be present.
  - Without a dryer, we are unable to realize the revenue stream assumed in the
- There is so much excess milk in California that producers can't find production homes for the milk and are discounting milk or dumping it.
- Mozzarella Fresca will reinvest in our plant and consume significantly larger volumes of milk and thereby return a dramatically better value to producers if we can procure milk at a more reasonable economic price.
- Mozzarella Fresca and Groupe Lactalis first support the Institute's proposal, and secondarily support the F&A et al proposal.
  - Our inability to capture the protein/whey value puts us at a distinct economic disadvantage.
  - The huge surplus of milk in California that I

Post-Hearing Brief

- Regarding our product transfer to our facility in Idaho – because ID is not in the Federal Order system, we have been able to negotiate price reductions, thereby making it more economically viable to increase our throughput at that facility.
- Respecting the Turlock plant closure, in reviewing the manufacturing costs, we note that utility costs, taxes, environmental regulations and general business operations are more conducive to cheese manufacturing in Wisconsin.

Crystal Cream and Butter Company in Sacramento (Crystal) – Sharon Hale

Testimony

- Believes that Crystal's milk handling experiences of the past few months are reflective of an overall supply/demand imbalance in California of the past few months are reflective of an overall supply/demand in California that was made worse by the unpredictable rise in dry whey prices.

- As a processor, Crystal ahs undergone significant changes over the past 18 months, including the sale of the company to H.P. Hood.
- Servicing schools with their milk supply has been part of Crystal's long standing history.
- Of the 12.9 million gallons of milk produced in California each day, Crystal's school business utilizes approximately 18,000 gallons.
- As a processor, Crystal is not guaranteed the minimum price when we sell milk nor do we expect to receive it when milk is long – in late June, discounts from $0.25 to $1.00 began to appear.
- By July, placing excess milk was becoming a full time job and costing more money as the state's milk prices continued to reach record highs.
  - It was then that we learned first hand that the state's pricing for Class 4b had reached critical mass for many of the cheese makers.
- Crystal was turned away by a cheese company, not for lack of capacity, but because they did not have whey processing capabilities and had already made the decision to scale back rather than incur unrecoverable costs in excess of $3.00 per hundredweight resulting from the Class 4b pricing formula.
- One of the many consequences of this supply situation was the lack of available tankers.
  - "Available" being the operative word because as plants filled to capacity, tankers became knows as "rolling silos" as they lined up around plants waiting to offload.
- More than one quarter of the total volume had to leave the state to be processed.
- The consequences of production without adequate processing capacity are the chaotic conditions we have seen over this past summer.
  - The Department now has both the opportunity and obligation to dull the price stimulation and encourage plant capacity within the state.
- Crystal supports the proposal put forth by the Institute because it addresses both the supply/plant capacity imbalance currently facing California and also alleviates the problems associated with including the dry whey factor in the Class 4b pricing formula.
- The Department's recently updated weighted average manufacturing costs for butter, NFDM, Cheddar, and dry whey powder should be incorporated into the appropriate class pricing formulas as proposed by the Institute.
  - An increase in the manufacturing allowances will provide the basis for consumers to see some benefit from the abundance of milk as the price adjustments work their way through the retail level.
- We have yet to hear of an equitable way to account for the variety of methods the cheese makers employ in handling their whey stream and until such time a method is found, we feel it is more appropriate to remove the dry whey factor from the Class 4b formula.
- Crafting the state's pricing system to differentiate between handlers based on size runs counter to the Department's charge to endeavor to achieve equal raw product cost for handlers operating in the same marketing area.
- The plant capacity credit proposal is appreciated because its focuses is on new capacity within the sate as a means of avoiding, or at a minimum, improving conditions in placing excess milk.
  - However, before long the Department would find itself with the knotty problem of trying to sort out who should get a credit for what.

Kraft Foods – Mike McCully

<u>Testimony</u>

- Consistent with prior testimony on this subject, we support the proposal from F&A Dairy to remove the whey factor from the 4b formula.
  - Also supports the alternative proposal submitted by the Institute.

- There are tenets of a regulated pricing system that are not being met in California: (1) must create orderly marketing conditions, and (2) establish a regulated price which allows the market to clear.
  - Milk production in CA continues to grow while in-state processing capacity has not kept up with this growth.
- To accommodate milk supply growth each year, it is imperative for the continued success of the CA dairy industry that the state fosters and builds additional manufacturing capacity.
  - However, not only are new plants not being built, but they're closing or moving out of state.
- Without significant new investment in plant capacity, the CA dairy industry will find it increasingly difficult to handle the growth in milk supplies.
  - Appendix 1 – the weekly USDA Dairy Market News fluid milk and cream report for 207.
  - The state has inadequate capacity to process growing milk supplies into products demanded by the marketplace.
- At each hearing, the Panel's recommendation was the same – remove the whey component from the 4b formula.
  - Excerpts from the 2005 and 2006 hearings recommending the removal of the dry whey factor are included in body of testimony.
- Appendix 2 is an editorial by John Umhoefer from the Wisconsin Cheese Makers Association in the August 3, 2007 Cheese Market News, providing additional documentation of the problem of attempting to value the whey stream.
- It is evident the addition of the whey component to the 4b price formula has introduced a multitude of problems not only in CA, but also in the FO system and needs to be removed.
- Kraft does not support any portion of the Alliance et al proposal because while the whey credit would help a handful of small plants, it ignores the impact the whey component is having on plants of all sizes.
- Supports LOL proposal to update the make allowances for butter, cheese, and NFDM, but do not agree with the method of calculating the whey manufacturing allowance.
- Opposes CDI proposal to use their own plant data rather than CDFA audited manufacturing cost data.
- Opposes Humboldt proposal to create a multi-tiered pricing system because it would add another layer of regulation to milk pricing.
- By definition, a minimum regulated price should be set so the market clears. If there is additional revenue generated form the milk, then it would be returned in the form of premiums, cooperative earnings, or other payments.
- The dairy markets have evolved from local to global in nature; 95 percent of the world's food consumers are outside the U.S., and the potential market is enormous.
- Unfortunately, outdate regulated systems are holding back the U.S. dairy industry from realizing the full potential of this opportunity.
- Kraft encourages the Department to adopt the F&A Dairy et al proposal as well as the alternate proposal by the Institute because they best address the needs of California's dairy industry and position both producers and processors for future growth.

Post-Hearing Brief

- Mr. Gossard asked about the plant expansions noted in the April 2006 Dairy Foods magazine article (Appendix 1) – only three out of 41 are in California.
- Answer to Mr. Shippelhoute's question regarding WCMA survey: "WCMA asked five plants for a snapshot of the value they earn for wet, skimmed whey. In June, this product earned between 10 and 20 cents per pound of solids compared to the 72 cents for dry whey noted by NASS."
- Mr. Gossard asked for a similar analysis to the one Kraft provided for the CA milk supply for prior years – summary table included in body of brief.

- Excerpts from weekly Dairy Market News for the past three years focusing on milk handling during the spring flush period, summer holidays, and the most recent week comparison have been included in the body of the brief.
- Also in the body of the brief is an excerpt from the latest USDA Market News reports on milk and cream supplies in California and surrounding states.
- Interesting points in the USDA article were that milk was being dumped on the farm and that several processors were implementing base plans to limit milk from producers.
- Given the number testimonies regarding the disposition of milk in California this year and the Panel's question regarding this, Kraft found it strange that the same questions were not asked of CDI.
- Kraft was not asked to provide details on milk leaving California, but if the Department is interested, Kraft would be happy to provide it as long as there is a way to do so confidentially.
  - The losses from handling milk surplus in CA are being borne by farmers now.
  - The question arises – Does the regulated pricing system in CA change to allow investment of in-state processing capacity or does it continue to be a source of cheap milk for out-of-state processors?
- At hearings in 2005 and 2006, proposals were made to remove the whey factor and each time the hearing Panel agreed.
- The best solution is to remove the dry whey factor from the 4b formula and also to implement the alternate proposal from the Institute.

Alliance of Western Milk Producers – William C. Van Dam

<u>Testimony</u>

- Disagrees with theory that whey has so little value that it should not be shared with producers via the Class 4b formula.
- Value of the whey component paid to producers from April 2003 to present is approx. $600 million. This value is the residual value of the whey after the MCA has been deducted from the formula.
- The total make allowance from the formula for same time period was $1 billion.
- The first five months the whey value was in the formula in 2003, it was a reduction of $9 million, but recovered by the end of the year to close at a negative $4 million. In 2007, the whey price peaked and 2007 will bring about $300 million to the producer.
- World demand for dairy products is very high.
- Believe the current formula is flawed, but not to the extent that the whey factor needs to be removed.
- When whey prices rose to unheard levels, made it difficult for some plants recover from WPC prices.
- Believes that the value of whey is substantial and should not be removed from the formula.
- Would be best to properly value the whey stream in the formula – not get rid of it.
- Evident from tables prepared by Dept. that plants processing less than 100,000 pounds of milk a day simply cannot economically justify investments in whey processing. Yet these plants must pay the full Class 4b price for their milk while being unable to recover any of that value.
- Future projections of higher whey prices will continue to be a problem for these smaller cheese plants.
- Carefully designed credits properly justified have served the industry well.
- Proposing credit for first 100,000 pounds of milk processed into cheese per day – all pool plants or those purchasing milk from pool plants get the credit.

- The small cheese plants add image and pizzazz to the industry.
- The larger plants could take this credit and use for plant investment purposes – would be approx. $28,500 per month.
- Table Exhibit C-1 attached to testimony points out the whey credit proposed would total approx. $874,221 monthly, while total value of whey component is just over $15 million. For the five highest months of 2007, the credit would amount to $2.5 million, with total whey value at $44 million.
- Intent of proposal was to focus credit on those who need it and create incentives to the other plants to invest in whey processing.
- Makes no sense to have the whey component to negative in the formula – so we are proposing a snubber.
- Since number of whey plants is falling to only two plants, proposed a different make allowance for whey as the NFDM make allowance plus $0.03.
- In favor of implementing a credit as proposed by CDI for plant expansion.
- Support the Class 4a make allowances as the cost justified MCA.
- No position on the Humboldt Creamery proposal.
- Pricing systems must consider the long term if they are to be effective for both producers and processors. Cannot allow short term abnormal situations to drive changes in the formulas will long term be harmful to industry.

Post Hearing Brief

- Same issues were discussed on plants processing less than 100,000 pounds of milk per day hurting with the current formula.
- Our proposed credit removes the whey factor problem for 58%of the cheese plants.
- Proposed an industry meeting to discuss dry whey and WPC values and the formulas.

Saputo Cheese USA – Greg Dryer

Testimony

- Supports the Institute's alternative proposal
- Saputo's philosophy is to satisfy customers, not to switch products whenever something else become more profitable
- Regulated prices' intent is to be market clearing – not a way to extract all potential value from finished products.
  - What producers receive should be reflective of supply and demand conditions. They are also entitled to protections afforded to them by government
  - Producers should not be entitled to the moment's optimum mix of dairy products
- Current system sends wrong signal to increase milk production when we need more capacity
- Whey is an issue for cheese processors in California and nationally – cheese plant business failures evidence this.
- Whey is not a problem only for small plants.
- With no whey processing capability, plants are left with costs in excess of those encompassed in the California study – moving liquid is expensive ($3-4 per loaded mile).
- Few companies dry skim whey. Most generate a whey protein concentrate stream and a lactose permeate stream. As the protein concentration increase, percentage of lactose permeate increase, which require further investments.
- Plant structure once established is very difficult to change.
- If benefits of innovation are arbitrarily taken from risk takers in price formulas, innovation, investment and risk taking will ultimately cease.

- California needs to be able to compete with other regions and currently it cost more to move milk then what the 4b-Class III price difference is.
- A longer period to calculate FOB adjuster will smooth out distortions.
- The state should adopt the current cost average at a minimum consistent with prior practice.
- Proposals that increase the 4b price, are discriminatory or difficult to administer should be rejected.
- The idea of a snubber should be interpreted as an argument in favor of the elimination of the dry whey component.
- If Department does not remove the whey factor, the MCA for whey should be at least increased to $0.3099.
- Signaling a willingness to manipulate regulations to achieve short term goals can serve as a deterrent to capital investment under that system.

Post Hearing Brief

- Saputo presented a simplistic model to represent the whey processing situation as it exists today in California. They found that with a 30 year life, adding back straight depreciation of $333,000 per year on $10 million and $667,000 on $20 million would still result in large net losses for both levels of investment. Their question is who would invest in such an environment. And if you don't, you are still obligated to pay producers as if you had.

Farmdale Creamery – Scott Hofferber

Testimony

- The producer community's claim that it is entitled to all of the value in the waste whey stream above some MCA amount, based on a product almost no one makes, is completely dismissive of the value-added nature of what whey processing cheesemakers do to to convert that waste material into something marketable.
- If no solution is found, processing capacity will decrease in the face of increasing milk supply.
- Oppose Alliance *et al.* proposal: its incongruity is plain to see as, on one hand, they dismiss the small cheesemakers' problem with the whey factor by claiming additional milk cost can be returned from the marketplace and on the other hand seeking relief for them.
- The snubber element is just another way to try to shelter the producer from risk.
- The root problem is of the producers' own creation: oversupply.
- Supports the Institute's proposal.
- Lag in implementing MCA has been significantly detrimental to Farmdale.
- For Farmdale to consider growth, the Department must recognize that the whey stream has no value.
- LOL proposal to simply update the MCA does not correct the whey factor.
- Humboldt's proposal is not sufficient and does not update the MCA.
- As long as the whey factor remains in the formula at anywhere near the impact it has had since 2003, the incentive proposed by CDI would not entice Farmdale to expand.
- The whey disposal or conversion costs are the cheesemakers' to bear, therefore any potential gain should be the cheesemakers' to keep.

Sierra Cheese Manufacturing Company Inc. – Charlene and Philip Franco

Testimony

- Supports the F&A *et al.* petition.

- Sierra do not dry whey and cannot financially or geographically consider adding a whey drying facility.
- The whey component has drastically changed Sierra's milk pricing, so much so that they suffered loss of business due to pricing factors and had to put off facility upgrades and expansion.

Post Hearing Brief

- Sierra cheese does 4-5 million dollars in sales every year and since the beginning of 2007, their losses are in the 6 figures range.
- If it was not for the money in their savings to pay for milk bills, they would quite possibly not have been at the hearing.

Ray Souza

Testimony

- Producers are still recovering from the worst record losses in their modern history.
- A large part of recovered prices are taken up by increased expenses – margins are getting narrower.
- Environmental regulations to come will be extremely costly.
- The Alliance *et al.* proposal address the issues brought up by the petitioners.
- Whey powder is also pooled everywhere in Federal orders and the whey MCA in California is 25% higher.
- Plant capacity is an issue, but far more complex than just reducing powder price. Even if whey was taken out, it would take six years to see an increase in plant capacity. Industry gatherings should be established to discuss that issue.

Post Hearing Brief

- The Alliance *et al.* was one of the broadest coalitions of producers and processors in recent times.
- Estimates indicate that an additional $21 million would have been transferred from producers to processors for the period September 2006-August 2007 had the dry whey credit been in place. This exemplify the producers' desire to do their fair share in resolving the petitioners' problem.
- Any dramatic change in the formula would jeopardize negotiations between producers and processors.

Leprino Foods Company – Sue Taylor

Testimony

- Supports the Institute's proposal
- Oppose Alliance et al, Humboldt and CDI's credit proposal.
- The cheese industry in California is under stress and being a "small cheesemaker issue" is not the cause.
- Several large cheese plants with whey processing capacity have experienced significant challenges.
- The Class 4b price generates a milk price that exceeds the revenue stream of the finished products being produced by many of the state's cheesemakers. This is contrary to sound policy and principles underlying minimum milk pricing.

- Removing the whey factor is the single correct policy choice because:
  - Dilute whey has no value in the marketplace. Even if it did, cheesemakers surely wouldn't be able to recover the value assumed in the 4b formula.
  - Whey processing is highly capital intensive which creates a barrier to entry for small cheese plants. The magnitude of the impact of adding whey in the formula was underestimated when whey was added – the run-up in whey prices over the last year was unexpected.
  - Returns disconnect amongst various whey products. It was thought that so long as the milk price was based upon sweet whey prices, the whey contribution to milk prices would not be overstated, but this is no longer true. Also, whey markets will not equilibrate as quickly as other markets (whey products fill different market niches that are driven by different demand factors, few plants can justify investing the substantial capital required to enable them to shift production among the whey products on the short term and substantial volumes of whey products are exported so they are subject to additional supply and demand factors).
  - There is no common whey product produced within California, and the nature of supply and demand make it impossible to identify a whey product that will accurately reflect market clearing returns generated by the whey complex on an ongoing basis.
- The MCA proposed by Alliance *et al.* is not desirable: because of scale differences, the base data for NFDM costs would significantly understate the costs of processing whey.
- CDFA's cost studies should be used to determine MCAs.
- Snubbers should not be used as it would preclude the formula result from reflecting the market values of the finished products at those times when market price falls below the MCA.
- The continued growth of milk production in California is well documented and it will necessitate additional plant capacity in California.
- Leprino is considering additional plant capacity. California is not being considered.
- Leprino oppose proposals by Humboldt and Alliance *et al.* as they would create regulatory inequities in an effort to mask economic forces.
- CDI's proposal is interesting but would not induce plant capacity: the significant capital required to build a cheese plant requires that it be a viable economic position for decades, not three years.
- Formula that establishes too high a price relative to finished product force processing capacity out of the sector and encourage milk production. This is today's situation.
- Marketplace responses to supply and demand factors are how producers garner a revenue stream that sustains their economic viability.
- Setting milk price above finished product value will cause the manufacturing sector to be unhealthy.

<u>Post Hearing Brief</u>

- Leprino's statement that product prices move independently does not mean that markets for whey products are completely isolated from each other. Rather, they do not use a common point of reference.
- Neither sweet whey nor the WPC-35 /lactose complex is an appropriate reference point for use in a regulated minimum milk price formula.
- There is a high level of variability between the gross returns of the alternative whey products.

California Dairy Women's Association - Linda Lopes

<u>Testimony</u>

- Support the Western United Dairymen, Alliance, and Milk Producers Council petition.
- Oppose the F&A et. al proposal to eliminate the dry whey factor.

- Producers are experiencing record high milk prices – but also facing record high feed costs.
- Producers are also facing environmental costs.

Dairy Producer: Joe Mendoza

Testimony

- Concerned with the cost of eliminating they dry whey factor.
- Producers are still facing high costs.
- The Institute proposal would put a tremendous burden on the producer.
- Producers are facing many problems and industry needs to meet to talk about the issues, in a slow manner.

Dairy Producer: Rien Doornenbal

Testimony

- Support the Western United Dairymen, Alliance, and Milk Producers Council petition.
- Even the most efficient producers in California are just breaking even the first months of 2007 with the higher milk prices – still recovering from prior 18 months.
- California dairy producers receive less than federal order producers – mailbox prices.
- Eliminating the dry whey factor would put California dairy producers at a severe economic disadvantage to those producing milk in neighboring states.
- Plant capacity is tight, but very little milk is being dumped.
- Has heard that there is some milk leaving the state.
- This year's weather has been very good for cows and milk production.
- Producers are maximizing production to take advantage of these high prices and recoup some of the loss of the last year.
- The Department does not need to be worried about plant capacity.