

# Hearing Panel Report

*Based on a Public Hearing Held  
August 28, 2007*

Addressing the Nonfat Dry Milk Price Series  
Contained in the  
Stabilization and Marketing Plans  
for Market Milk for the  
Northern and Southern California Marketing Areas and  
the Reporting Requirements for the  
California Weighted Average Price  
for Nonfat Dry Milk

## Hearing Panel Report

### Addressing the Appropriate Price Series for Nonfat Dry Milk Based Upon a Public Hearing Held on August 28, 2007

This hearing served two purposes:

- 1) To receive testimony for suggested changes to the Stabilizations and Marketing Plans regarding which nonfat dry milk (NFDM) prices series is appropriate for the Class 4a and Class 1 pricing formulas:
  - a. The California Weighted Average Price (CWAP) for NFDM currently being used by the Department; or
  - b. The NFDM – West Mostly Price for low/medium heat developed by USDA's Dairy Market News (Western DMN); and
- 2) To receive suggested changes to the reporting procedures for the collection of the weekly and monthly NFDM prices.

This report of the Hearing Panel is divided into two sections. The first section examines the proposed amendments to the Stabilization and Marketing Plans for Northern California and Southern California (Plans) and the second section reviews procedural changes to the CWAP for NFDM. Both sections are based on evidence received into the Department of Food and Agriculture (Department) 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 Tuesday, August 28, 2007, and written post-hearing briefs.

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## INTRODUCTION, SUMMARY OF PROPOSAL AND WITNESSES

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

Petitions were submitted by:

1. Western United Dairymen (WUD)
2. Milk Producers Council (MPC)

Two alternative proposals were submitted by:

3. Dairy Institute of California (Institute)
4. Alliance of Western Milk Producers (Alliance)

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

\*Hyrum Doegey, Department

Tiffany LaMendola, WUD

\*Geoffrey Vanden Heuvel and John Kaczor, MPC

William Schiek, Institute

William C. Van Dam, Alliance

\*Joe Heffington, California Dairies, Inc. (CDI)

Tom Wegner and James Gruebele, Land O'Lakes (LOL)

Patty Stroup, Nestlé USA and Dreyer's Grand Ice Cream Holdings, Inc. (Nestlé/Dreyer's)

Scott Magnuson, California Dairy Campaign (CDC)

*\* indicates witnesses submitting post hearing briefs*

In addition, two written statements were submitted by:

Jerry Kozak, National Milk Producers Federation (NMPF)

## SUMMARY OF PROPOSAL

The Department received only one proposal (from MPC) to change the pricing series used in the Class 4a and Class 1 pricing formulas.

MPC proposed changes to the method used to determine the market value of nonfat dry milk (NFDM) used in the Class 4a formula and in the Commodity Reference Price of the Class 1 pricing formula:

- Class 1 Pricing Formula: Use the simple average of the two most recent weekly Western DMN prices as published in the Dairy Market News (DMN) available on the 10th day of the previous month.
- Class 4a Pricing Formula: Use the simple average of the Western DMN as published in the Dairy Market News (DMN) from the 26th day of the previous month through the 25th day of the current month. (If not available, use the prior month's Western DMN price calculation.

The positions taken by the interested parties on the appropriate NFDM price series to be used in the Class 4a and Class 1 pricing formulas were:

- Those favoring continued use of the CWAP:
  - WUD
  - Institute
  - Alliance
  - CDI
  - LOL
  - Nestlé/Dreyer's
- Those favoring use of Western DMN:
  - MPC
  - CDC

## 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 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

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.

## Section 1

### APPROPRIATE PRICE SERIES FOR NONFAT DRY MILK (NFDM)

#### Issue

On both a weekly and monthly basis, the Department receives sales reports for NFDM from California processing plants. Both the weekly and monthly reports are subject to detailed reviews by the Department. Staff also audits the monthly reports prior to their use in the Class 4a price calculation; the weekly reports are subject to a post audit as part of the monthly audit. Currently, the Class 4a pricing formula and the Commodity Reference Price used by the Class 1 pricing formula utilizes the CWAP for all Grade A and Extra Grade NFDM for human consumption sold f.o.b. California manufacturing plants.

On average for the year 2000 through most of 2006, the CWAP, Western DMN, and National Agricultural Statistics Service (NASS) prices for NFDM remained within three cents per pound of each other. For the same period, Oceania skim milk powder (SMP) prices averaged as much as 30 cents below to 10 cents above the other three prices.

This situation changed dramatically starting in late 2006. From October 2006 through March 2007 while the NASS and CWAP prices stayed within 5 cents of each other, both the Oceania and Western DMN prices rose above the other two. The Oceania price went from 15 cents in October to 35 cents in March above the NASS and CWAP prices, while the Western DMN price went from 5 cents in October to 15 cents in March above the NASS and CWAP prices. This change in relative prices caused many in the dairy industry to question how reflective the NASS and CWAP prices were of actual market conditions for NFDM.

USDA undertook a review of the NASS price series and discovered that not all reporting plants followed the required specifications. Following the review, USDA published revisions for the NASS prices for NFDM used in the Class IV pricing formula from April 2006 through April 2007 and in the Class I pricing formula from June 2006 through May 2007. As a result, the NASS price is now more in-line with Oceania and Western DMN prices. With the CWAP specifications differing from the NASS specifications, the CWAP price continued to remain below the other prices until June 2007.

#### Review of Proposals

This discrepancy between the CWAP prices and other prices for NFDM was the underlying cause for the proposals to replace the CWAP with an alternative NFDM price series. This section addresses the proposal to replace the CWAP with the simple average of the Western DMN price series:

- For Class 4a, those weekly prices announced between the 26<sup>th</sup> of the prior month and the 25<sup>th</sup> of the current month; and
- For Class 1, the two most recent weekly prices available on the 10<sup>th</sup> of the prior month.

## Impact of Proposals

The table below shows the average price changes resulting from replacing the CWAP with the Western DMN NFDM price series. The changes shown are the averages for the years 2002 through 2006 and the averages of the months January through July 2007:

### Estimated Impact of Proposed NFDM Price Series (Western DMN) January 2002 - July 2007

	Class 4a (\$/cwt)	Classes 2 & 3 (\$/cwt)	Class 1 (\$/cwt)	Quota & Overbase (\$/cwt)
2002 through 2006	\$0.10	\$0.08	\$0.01	\$0.03
1st 7 months 2007	\$2.65	\$1.58	\$0.35	\$0.87

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.

## Discussion

The proponents of the proposal to replace the CWAP with the Western DMN stated that the current pricing formulas do not comply with the law, specifically Section 62062 of the Food and Agricultural Code (Code). According to this section, if the Secretary adopts methods or formulas to designate prices, the resultant prices shall be in reasonable and sound economic relationship with the national value of manufactured milk products. Within the same section, the Code also instructs the Secretary to “*take into consideration **any** relevant economic factors...*” (bold provided for emphasis) that are not limited to income, adequate and continuous supply, class prices that bear a reasonable and sound economic relationship to each other. Within Section 62062 and other sections of the Code, the Secretary is required to review a wide array of economic factors when establishing the price for milk. As mentioned by the proponents, because of the complexity involved and because of the consideration given to numerous different factors, the Secretary has broad latitude when setting milk prices. Since the Secretary does in fact take into consideration many pertinent factors when making milk pricing decisions in California, the Panel believes that the Secretary has been in compliance with the law.

In order to properly price milk produced and processed in California, economic factors that specifically affect California must be taken into consideration. Thus, the Department considers the needs of both California producers and processors in order to assure an adequate supply of milk for California consumers. In essence, the Department must strike a balance that will provide the best opportunity for the California dairy industry to function in the best manner possible.

The testimony of the Alliance cites a few important points regarding the CWAP:

*“...The basic idea behind the California Weighted Average Price (CWAP) was to use the **actual** values received by California plants for standard NFDM as the basis for determining what those plants paid for their milk. Looking back*

*over the past one third of a century, one has to be impressed by how well this approach has worked for both producers and processors.*

*...The required changes were few and far between and the flexibility served the industry well. The proposal put forth by others at this hearing would create a regulatory environment that moves away from a system that has worked well for over three decades based on the very unusual price and market circumstances that occurred during a short period in 2007.”*

The time period from the end of 2006 to the first part of 2007 was unique with conditions including increasing international demand for dairy products, reduced exports of dairy products by Australia and the European Union, and California being in the position to develop into a significant exporter of dairy products. These are a few of the conditions that created an unusual environment where the CWAP diverged from the other NFDM price series for a relatively short period of time, contrary to how the CWAP has historically tracked with the other NFDM prices.

In recent months, the CWAP has converged back with the other price series. One concern mentioned frequently in the testimony was the adverse effect fixed price long-term contracted sales have had on the CWAP, which caused divergence from the other price series and could cause other episodes of divergence in the future. However, as outlined in Section 2, the Panel addresses the issue of fixed price long-term contracts by imposing a time limitation that will keep certain extended fixed price long-term contracted sales from being included in the CWAP. This change will alleviate this concern over extended fixed price long-term contracted sales.

Proper consideration of the market conditions affecting the State of California requires economic data and factors specific to California, such as the actual values for NFDM received by California plants. The basic signal that affects supply and demand decisions in the market place is price. By using verified, audited California NFDM price data, the players that make supply and demand decisions receive the correct pricing signals affecting the California market. California specific data is the best information describing the California dairy landscape for the benefit of the Californian dairy industry.

In proposing the replacement of the CWAP with the Western DMN, the proponents argued that their proposal would bring California milk prices into alignment with national values. The Federal Orders system utilizes the NASS price series for NFDM to establish federal milk prices. With its soon to be implemented auditing process, this NASS survey procedure will be similar to the CWAP procedure. However, the Western DMN series for NFDM is neither audited nor a weighted average price (see details below). Replacing the CWAP with the Western DMN price series would be an inconsistent choice to make if the goal is maintaining alignment with national prices. The establishment of the Western DMN price series for NFDM is very different compared with the NASS and CWAP price series. Therefore, the Panel finds that to achieve alignment with national values, it would be inappropriate to use a NFDM price series, such as the Western DMN, which has different characteristics than the NASS and CWAP.

MPC stated that USDA Agricultural Marketing Service (AMS) contacts larger processors in eleven western states and buyers, which include brokers and end-users. Furthermore, MPC advised that AMS strives to assure confidentiality, obtain consistent and unbiased information, and monitors for responses that may be unrepresentative of the market. The

Panel agrees that the AMS does a good job of describing general regional pricing conditions for different commodities, such as NFDM, and they are acceptable as general indicators of regional market conditions. However, the Panel finds the AMS reporting procedure does have some limitations that affect the suitability for use in pricing formulas.

First, the DMN supplies a reported price range where the majority of sales take place and is transaction driven, but not volume-weighted. By not knowing how much volume is being sold across the range, one cannot determine where in the range the true price falls. Therefore, the reported price range is not as accurate as a weighted average price, like the NASS or the CWAP.

Second, AMS does not audit the reported information in order to verify its accuracy. Because reporting mistakes occur, it is important to audit price figures. This is evident by the USDA review of the NASS price series for NFDM with its subsequent revision and interim final rule. After it was announced that USDA had discovered that there had been reporting errors in the NFDM prices by plant participants, the governmental agency responsible for compiling the information was severely criticized for not implementing a prior mandate requiring the audit and data verification of NFDM prices. Various national and regional farmer organizations have taken the position that the long-term solution to prevent misreporting from happening is the implementation of mandatory auditing of NFDM prices. There is no auditing process involved in the reporting of NFDM prices by Dairy Market News or any pending actions to implement this critical safeguard. As a result, the Western DMN price series is less suitable for use when compared to an audited, weighted average price series such as the CWAP.

The CWAP protocol has historically relied on the auditing process to ensure accurate NFDM price reports. The Panel strongly believes that this has been important in assuring that the problem that occurred with the NASS price series has not occurred with the CWAP price reports. The Panel does not believe that it makes sense to switch to another process which would in any way lessen this critical protection to all parties that are interested in the most accurate California NFDM price.

### **Panel Recommendation**

The Panel recommends continuing to use the CWAP as the NFDM price used in the Class 1 and Class 4a pricing formulas.

## Section 2

### REPORTING REQUIREMENTS FOR THE CWAP FOR NFDM

The Panel is incorporating changes to the CWAP reporting forms in the Panel report. Any changes to the CWAP reporting requirements going forward will be adopted through a Department Administrative Order.

#### Background

Since 1973, the Department has utilized sales reports to collect data from California processing plants producing NFDM. Presently, the sales reports include all types of Extra Grade and Grade A NFDM sold to wholesale customers for human consumption, regardless of length of storage, container size, or sales volume. The reported types of NFDM include low-, medium-, and high-heat, vitamin-fortified, organic, and rBST-free; however, the reports exclude sales of other powdered milks such as instant NFDM, whole milk powder, skim milk powder, and skim milk powder blends. In addition, all types of sales are included in the reports, such as spot market sales, long-term and short-term contract sales consisting of fixed or indexed prices, and Commodity Credit Corporation (CCC) purchases under the Dairy Price Support, DEIP sales, and related federal programs. The Department excludes some sales from the reports, specifically intra-company sales to other plants that belong to the same organization or cooperative as the reporting plant. Using the sales data from all reporting processing plants, the Department then computes a weighted average price of NFDM called the CWAP.

The methodology of the auditing procedure has been essentially the same since 1973, except for a change that occurred in 1996. Prior to 1996, if the total weekly or total monthly weighted average NFDM price sold and reported by an individual processing plant was below the federal support purchase price offered through the Commodity Credit Corporation, then the reported price of the plant was increased or adjusted upward to the level of the federal support purchase price for the calculation of the CWAP. Since 1996, however, all NFDM prices in the current sales reports are not adjusted and are considered at their reported price in the calculation of the CWAP.

#### Issue

During the spring of 2007, members of the industry initiated discussion regarding the CWAP and the auditing procedures used by the Department to establish the CWAP. Customarily, the NFDM sales reports, reporting requirements and the procedures used by the Department to collect and audit NFDM sales information are a result of input from the California dairy industry. The Department has historically held informal stakeholder meetings in order to discuss and initiate changes to the procedures. Accordingly, there was a stakeholder meeting to discuss this issue on May 16, 2007, and also further discussion during the Dairy Advisory Council meeting on May 31, 2007.

On June 15, 2007, WUD petitioned the Department for a public hearing to revise the weekly and monthly NFDM sales reports. Shortly thereafter on June 18, 2007, Milk Producers Council MPC petitioned the Department for a public hearing to amend the Stabilization Plans by replacing the CWAP with a NFDM price series published in the Dairy Market News.

On June 29, 2007, the Department called a public hearing for August 28, 2007, to consider the MPC proposed amendments to the Stabilization Plans, the WUD proposed revisions to the NFDM sales reports and any other alternative proposals. Two alternative proposals were submitted to the Department by Alliance and the Institute both proposing different revisions to the NFDM sales reports.

The following two tables show a summary of positions taken regarding changes to the CWAP reporting procedures and a summary of the recommended revised reporting procedures.

Summary of Positions Taken Regarding changes to CWAP Reporting Procedures<sup>1/</sup>

	CDFA Previous	WUD	Institute	Alliance	LOL	Nestlé/ Dreyer's	NMPF	CDFA Revised
	Instant	Exclude	4/					Exclude
	Fortified	Includes	4/					Includes
	High Heat	Includes	Exclude			Exclude		Includes
	Organic	Includes	Not Oppose Exclusion	4/	Exclude	Exclude	Exclude	<b>Exclude</b>
	rBST free	Includes	4/					Includes
	Age	Any	180 Days Limits <sup>5/</sup>					Any
	Container	Any	Exclude 30 Days <sup>6/</sup>		Exclude 90 Days <sup>6/</sup>	Exclude 30 Days <sup>6/</sup>	Exclude 90 Days <sup>2/ 6/</sup>	<b>Exclude 150 Days<sup>7/</sup></b>
<b>Long Term Contracts</b>	Fixed	Includes	4/					Includes
	Indexed	Includes	4/					Exclude
	Intra Co. Sales	Exclude	4/					Exclude
	Resale	Exclude	4/					Exclude
	Transporting Clearing Costs	Exclude	4/					Exclude
	Other <sup>3/</sup> Types	Exclude	4/					Exclude
	Date	Shipping	4/					Shipping maybe deducted
	Energy Surcharges	Include	4/					maybe deducted
	Brokerage Fees <sup>8/</sup>	Exclude	4/					maybe deducted

<sup>1/</sup> CDI and CDC made no recommendations for changes to the CWAP. MPC said that if the CWAP were kept, the Institute position would be a poor second choice.

<sup>2/</sup> 30 days for domestic contracts.

<sup>3/</sup> Buttermilk powder, skim milk powder, whole milk powder, any whey stream products.

<sup>4/</sup> The Institute proposed adopting the USDA standard on this issue, but did not give specific supporting testimony.

<sup>5/</sup> 25 kg., 50 lb., totes, and tanks only.

<sup>6/</sup> From the date the contract is signed

<sup>7/</sup> From the date when the first shipment is made under the contract

<sup>8/</sup> Must be an arms length relationship

## Summary of the Revised Reporting Procedures for California NFDM Production and Revenue

Issue	What USDA does	What California does	Panel Recommendations	Arguments
Organic	Exclude	Include	Exclude	All Hearing testimony favored excluding Organic NFDM from the CWAP. NFDM used in the minimum price calculation is the basic commodity. Organic NFDM is perceived in market as providing a value added product over the basic commodity.
rBST Free	Exclude	Include	Include	No request for change
Vitamin-fortified	Exclude	Include	Include	DI favored adoption of policies that would bring CWAP and NASS price calculation in alignment Prior to including this factor, the Panel believes it is important to perform some analysis regarding the significance of fortified NFDM volume and price on CWAP. No information is currently available to do so.
Age of powder (180 days old)	Exclude	Include	Include	DI favored adoption of policies that would bring CWAP and NASS price calculation in alignment. This was not an important issue for most hearing witnesses. Administratively problematical
Instant	Exclude	Exclude	Exclude	No request for change
Other types of powder (skim milk, whole milk, dry buttermilk, instant NFDM, dry whey products)	Exclude	Exclude	Exclude	No request for change
Intra-Company Sales	Exclude	Exclude	Exclude	No request for change
Resale	Exclude	Exclude	Exclude	No request for change
Transportation and Clearing charges	Exclude	Exclude	Exclude	No request for change
Energy Surcharges	Include	Include	Include	No request for change
Brokerage Fees	Include	Exclude	Exclude	No request for change
High heat	Exclude	Include	Include	DI favored adoption of policies that would bring CWAP and NASS price calculation in alignment. This was not an important issue for most hearing witnesses. Department's manufacturing cost data reflects NFDM volume that includes low, medium, high heat NFDM. DI testified that the high heat should be excluded – which is problematical at this time.
Indexed price contracts	Include	Include	Include	No request for change
CCC purchases under dairy support program and DEIP	Include	Include	Include	No request for change
Sales date for Sales Report	Ship date	Ship date	Ship date	No request for change
Fixed price long-term contracts	Exclude (30 days)	Include	Include up to 150 days	See discussion next page

## Revision of the CWAP reporting procedures

At the August 28, 2007 hearing, changes pertaining to a number of issues were requested. However, the main concern was the inclusion of long-term contract NFDM sales in the calculation of the CWAP. For concerns other than long-term contracts, the Panel did not receive extensive testimony to justify significant changes to the reporting procedures. After reviewing the testimony, comments and data offered, the Panel came to the following conclusions:

- **Organic NFDM:** NFDM used in the minimum price calculation is the basic commodity, whereas organic NFDM is perceived in the market as providing value added to the product over the basic commodity.
  - Organic NFDM should be excluded from the CWAP.
- **Vitamin-fortified NFDM:** Prior to making a change on the exclusion of this powder, the Panel believes it is important to perform some analysis regarding the significance of vitamin-fortified NFDM volume and price on CWAP. No information is currently available to do so.
  - Vitamin-fortified NFDM should continue to be included in the CWAP.
- **High heat NFDM:** The Department's manufacturing cost data reflects NFDM volume including low, medium and high heat NFDM, which would be problematical at this time for the exclusion of high heat NFDM from the CWAP.
  - High heat NFDM should continue to be included in the CWAP.
- **Age of powder (180 days old):** This would be administratively problematical at this time.
  - Powder, regardless of the age, should be included in the CWAP.
- **Instant NFDM, other types of powder (skim milk, whole milk, dry buttermilk, instant NFDM, and dry whey products), intra-company sales, re-sales, transportation and clearing charges, broker fees:** Currently excluded from the CWAP and no requests were made for change.
  - Remain unchanged.
- **Indexed price contracts, energy surcharges, CCC purchases under dairy support program and DEIP sales:** Currently included in the CWAP and no requests were made for change.
  - Remain unchanged.
- **Sales date on Sales Report:** No requests were made for a change.
  - To clarify the Sales Report, the Panel recommends that if the invoice date is different from the ship date, the sale is considered on the ship date.

Lastly, **fixed price long-term contracts**, was one of the main issues at the hearing. Testimony was received to either include all long-term contracts sales in the CWAP, include them up to 90 days or exclude them (short contracts sales up to 30 days can be included). Historically, the CWAP has included the spot market sales, long-term and short term contract sales consisting of both fixed or indexed prices, and CCC sales of NFDM. NASS has historically published its own NFDM price series. NASS designed the series to exclude the NFDM sales that are over 30 days old and any long-term contracts with fixed prices.

Over the years, the surplus in national production of NFDM has kept NFDM prices very stable at or near the federal price support levels. Consequently, both the CWAP and the NASS prices have been very consistent, tracking remarkably close.

With sharply reduced supplies from both Australia (a consequence of extended national drought) and Europe (a consequence of reduced governmental export subsidies), the world market for NFDM became significantly tighter in early 2007, causing sharp increases in NFDM prices. During this period, the differential between the CWAP and NASS NFDM prices began to increase.

A growing controversy around the accuracy of the NASS procedures for establishing NFDM prices developed during 2007. While the accuracy or compliance with the established CWAP process never materialized, there was a slightly different controversy within the California dairy producer community over the incorporation of long-term fixed price contracts in the establishment of NFDM prices via CWAP.

California's NFDM sales were reflecting an increasing volume of product sold on the world market via fixed price long-term contracts. More importantly, the fixed price long-term contracted sales carried a significantly lower price relative to current domestic sales. It caused the CWAP to be lower than the NASS price series.

The issue of long-term fixed price contracts for determining the NFDM price is the focus of attention within both California and the federal milk marketing order system. Both the USDA and the Department are reviewing this issue.

The hearing testimony concerning the inclusion of fixed price long-term contracts revolved around two main issues:

- Should there be a time limitation on contracts that are included in the reported sales used to calculate the CWAP;
- If there is a limit on the time it takes to fulfill a contract to be included in the CWAP and how many days should that limit be?

Regarding the first issue, CDI and the Alliance testified that the status quo should be observed. They both argue that the current reporting procedures, which do not limit any NFDM contracts included in the CWAP, have served the industry well for many years and taking out long-term contracts would curtail potential markets. In part, the LOL testimony reflected a similar opinion as they explained the international contracts can take a long time to fulfill and excluding such sales could have an adverse impact on California export sales.

Many hearing witnesses testified in favor of limiting the inclusion of fixed price long-term contracts from the calculated CWAP. Opinions varied, however, regarding the duration of fixed price contracts that should be included in the CWAP.

Witnesses recognized the importance of export markets for California NFDM; they also expressed concerns that including all fixed price long-term contracts would not reflect the current market value of NFDM. WUD proposed to set a time limitation on long-term contracts sales to be included in the CWAP so the risk of losing potentially higher or lower contracted prices, depending on how prices are moving, could be borne by both producers and manufacturers.

The Institute and Nestlé/Dreyer's strongly supported that idea as they are concerned the current procedure sends the wrong market signals. As the Institute's testimony indicated, "...market participants have no idea what the CWAP price will be, or even whether it will increase or decrease because the price is a function of how much volume is delivered on each contract on a given week or month. The result is somewhat chaotic for those buyers who are trying to budget and plan for what their costs will be."

More specifically, testimony submitted by the Institute and Nestlé/Dreyer's requested the exclusion of fixed price contracts fulfilled beyond a 30-day period. WUD, LOL and NMPF argued that a limit should be set at 90 days. Thus, the August 28, 2007, hearing presented the challenge of balancing the competing interests of all the parties and reaching a decision that would best serve California and the California dairy stakeholders.

Based on all the testimony and evidence, it is clear that export markets take time to develop and that these markets allow California to stay competitive. The Panel reached the conclusion that long-term fixed price commitments facilitate sales of NFDM products in international markets. The United States Dairy Export Council (USDEC) information and testimony from LOL and CDI showed that the norm in international markets is medium to long-term contracts (6-12 months). Moreover, export contracts are typically a future commitment and not based on inventory, and these exports require a considerable amount of paperwork. The majority of the long-term fixed price contracts, therefore, do not even start shipment of their obligations within a month of the agreement.

The Panel has concluded that exclusion of long-term contracts to a relatively short time period places additional risk on California NFDM manufacturers, making them more reluctant to commit to export sales. Since exports of California NFDM are a growing and significant element of California NFDM sales, this would result in serious financial consequences to the California dairy industry. Given California's annual milk production growth rate of three to four percent, all sales including export sales are critical in the successful marketing of California's growing milk supply.

The Panel also strongly believes that long-term fixed price contracts are a strategic option whose maintenance allows the California dairy industry to compete successfully in world markets. The long-term success of the California industry will increasingly rely on these markets.

The Panel recognizes that a single organization markets most California NFDM. Any contracting decision made by this organization impacts all California dairy stakeholders. When marketing NFDM, any fixed price long-term contract this organization enters into has the potential, either positively or adversely, of affecting all stakeholders. Given, however, the potential consequences of an adverse marketing decision on California dairy stakeholders, and out of an abundance of caution, the Panel strongly believes it is appropriate and reasonable to set some time limit on the duration of long-term fixed price contracts that can be included in the CWAP.

The proponents of the proposed 30- or 90-day time limit generally used subjective arguments that did not provide much objective justification. WUD even testified that it proposed the 90-day limit as a means of encouraging more focused discussion. The Panel believes that the testimony for 30- or 90-day time limits was too subjective to be a basis for making this critical decision.

To ensure the CWAP reflects California's NFDM sales, it is important to understand that a number of long-term fixed price contracts run well beyond 90 days. The data provided in the CDI post hearing brief regarding Dairy America's sales clearly illustrates this point:

- With only 22% of the volume exported under contract in the last year and a half was fulfilled within the 90-day period.
- While 57% of the contracts were completed within a 150-day period.

Based on this information, the Panel has concluded that the CWAP should include fixed price contract sales that are within 150 days of the first shipment date. This will provide enough flexibility to ensure that the California NFDM processors retain the ability to obtain and complete export sales. The Panel believes this term will provide the limitation necessary to allow for a more current milk value to producers, but will also ensure the continued success of California export sales. Consequently, the Panel recommends amending the reporting instructions to require manufacturers to include their contract provisions in order to track sales that are part of fixed price contracts (see next pages 18-21).



## Weekly Nonfat Dry Milk Sales Report

The Dairy Marketing Branch collects weekly information on nonfat dry milk (NFDM) sales and prices in order to compute the weekly “sales quantity” weighted average NFDM price for California. Prices are collected for the seven-day period Saturday through Friday of each week. This calculated price, as well as the weekly total NFDM sales volume will be forwarded to the Federal Market News Service for publication in the *Dairy Market News*.

**Report Due Date:** The Weekly Nonfat Dry Milk Sales Reports and detailed summary sheet (see back page) are due to the Dairy Marketing Branch no later than 10:00 a.m. on the Tuesday following the seven-day (Saturday-Friday) period of this Report.

**Instructions:** Please note the following instructions (and those on the reverse side) for completing this sales report. Should you have any questions, please contact the Dairy Marketing Branch at (916) 341-5988. Your timely cooperation in supplying this information is greatly appreciated.

**Reporting of NFDM:**

- Report all sales of USDA Extra Grade, Grade A, vitamin-fortified, and rBST-free nonfat dry milk (exclusions noted below)
- Reported sales shall include all container sizes and all sales regardless of volume or length of storage
- The sales transaction is considered completed when the nonfat dry milk is “shipped” and title transfer occurs
- Prices are F.O.B. processing plant/storage center

**Included in the Sales Report:**

- Nonfat dry milk for human consumption, using low, medium, and high heat
- CCC purchases under the Dairy Price Support, DEIP sales, and related federal programs
- Total volume sold, total dollars received, and price per pound
- Fixed price contract sales within 150 days from first “shipment” date
- All indexed contract sales
- Energy surcharges

**Excluded in the Sales Report:**

- Sales of Organic nonfat dry milk
- Sales of skim milk, whole milk, dry buttermilk, instant nonfat dry milk powders, and dry whey products
- Intra-company sales and re-sales of purchased nonfat dry milk
- Transportation charges, clearing charges and broker fees

<b>Sales Period Covered:</b> Saturday _____ through Friday _____			
<b>Commodity Credit Corporation Sales</b>			
<b>Company Name</b>	<b>Pounds of NFDM</b>	<b>Total Dollars Received</b>	<b>Dollars Per Pound</b>
	Lbs.	\$	\$ /per pound
<b>All Other NFDM Sales</b>			
<b>Company Name</b>	<b>Pounds of NFDM</b>	<b>Total Dollars Received</b>	<b>Dollars Per Pound</b>
	Lbs.	\$	\$ /per pound
<b>Total All Sales</b>			
	Lbs.	\$	\$ /per pound

I hereby certify that the above report, to the best of my knowledge and belief, is correct.

Signature \_\_\_\_\_ Print Name \_\_\_\_\_

Title \_\_\_\_\_ Phone \_\_\_\_\_ Email \_\_\_\_\_

## **REPORTING INSTRUCTIONS** **(Weekly Report)**

This report is for disclosing sales of Extra Grade, Grade A, vitamin-fortified, and rBST-free nonfat dry milk only, sold for human consumption, regardless of length of storage, container size, or sales volume. Do not include any other type of powdered milk, such as organic, instant NFDM, skim and whole milk powders, and dry whey products. The selling price of NFDM will include any container costs.

**Period Covered:** The weekly time frame of Saturday through Friday of any given week will be the basis for determining the amounts of reported nonfat dry milk product and sales. Include only the sales shipped during that specific time frame when reporting.

### **Completing the Volume/Sales Section:**

**Company Name:** Indicate company name.

**Commodity Credit Corporation Sales:** Total the Commodity Credit Corporation (CCC) sales under the support purchase price program for the week in question - this is reported in pounds sold and total dollars received.

- Please note that sales of NFDM should be reported at the price sold without regard to whether the price is lower than any existing support purchase price.

### **All Other Sales:**

**Pounds of NFDM:** Total the pounds of NFDM sold. Do not include:

- Sales or transfers to other plants in the same company or cooperative association (intra-company sales);
- Sales of organic, skim and whole milk powder, dry buttermilk powder, instant NFDM, and dry whey products;
- Re-sales of purchased NFDM.

**Total Dollars Received:** Total the dollars of sales for the week in question including energy surcharges (arms-length transaction).

**Exclude:** Transportation, clearing charges and broker fees from total dollars received. If the processing plant delivers product in their own trucks and the plant cannot separate their delivery cost from their delivered price to achieve an F.O.B. plant price, then this sale shall not be reported.

**Credits:** Credits for sales are to be included in the weekly report only if the original sale was in the same week as the credit week. Other credits for prior week sales are not to be included.

**Total Sales:** Total the CCC sales information and All Other NFDM sales information.

### **Detailed Summary Sheet:**

Please include the following:

Invoice Date and Invoice Number  
Shipping Date  
Customer Name  
Plant Producing the NFDM  
Product Type  
Actual Pounds/Quantity  
Unit Price  
Broker Fees  
Energy Surcharges  
Total Dollar Amount  
Identify Fixed Price and Indexed Contract Sales



## Monthly Nonfat Dry Milk Sales Report

The Dairy Marketing Branch collects information on nonfat dry milk (NFDM) sales and prices in order to compute the monthly “sales quantity” weighted average NFDM price for California which is used in computing minimum prices to be paid for Class 1, 2, 3, and 4a solids not fat in California.

**Report Due Date:** The Monthly Nonfat Dry Milk Sales Reports and detailed summary sheet (see back page) are due to the Dairy Marketing Branch no later than 10:00 a.m. on the last business day of the month.

**Instructions:** Please note the following instructions (and those on the reverse side) for completing this sales report. Should you have any questions, please contact the Dairy Marketing Branch at (916) 341-5988. Your timely cooperation in supplying this information is greatly appreciated.

**Reporting of NFDM:**

- Report all sales of USDA Extra Grade, Grade A, vitamin-fortified, and rBST-free nonfat dry milk (exclusions noted below)
- Reported sales shall include all container sizes and all sales regardless of volume or length of storage
- The sales transaction is considered completed when the nonfat dry milk is “shipped” and title transfer occurs
- Prices are F.O.B. processing plant/storage center

**Included in the Sales Report:**

- Nonfat dry milk for human consumption, using low, medium, and high heat
- CCC purchases under the Dairy Price Support, DEIP sales, and related federal programs
- Total volume sold, total dollars received, and price per pound
- Fixed price contract sales within 150 days from first “shipment” date
- All indexed contract sales
- Energy surcharges

**Excluded in the Sales Report:**

- Sales of Organic nonfat dry milk
- Sales of skim milk, whole milk, dry buttermilk, instant nonfat dry milk powders, and dry whey products
- Intra-company sales and re-sales of purchased nonfat dry milk
- Transportation charges, clearing charges and broker fees

<b>Sales Period Covered:</b> _____ through _____			
<b>Commodity Credit Corporation Sales</b>			
<b>Company Name</b>	<b>Pounds of NFDM</b>	<b>Total Dollars Received</b>	<b>Dollars Per Pound</b>
	Lbs.	\$	\$ /per pound
<b>All Other NFDM Sales</b>			
<b>Company Name</b>	<b>Pounds of NFDM</b>	<b>Total Dollars Received</b>	<b>Dollars Per Pound</b>
	Lbs.	\$	\$ /per pound
<b>Total All Sales</b>			
	Lbs.	\$	\$ /per pound

I hereby certify that the above report, to the best of my knowledge and belief, is correct.

Signature \_\_\_\_\_ Print Name \_\_\_\_\_

Title \_\_\_\_\_ Phone \_\_\_\_\_ Email \_\_\_\_\_

## **REPORTING INSTRUCTIONS** **(Monthly Report)**

This report is for disclosing sales of Extra Grade, Grade A, vitamin-fortified, and rBST-free nonfat dry milk only, sold for human consumption, regardless of length of storage, container size, or sales volume. Do not include any other type of powdered milk, such as organic, instant NFDM, skim and whole milk powders, and dry whey products. The selling price of NFDM will include any container costs.

**Period Covered:** The monthly time frame beginning on the 26<sup>th</sup> of one month and concluding on the 25<sup>th</sup> of the next month will be the basis for determining the amounts of reported nonfat dry milk product and sales. Include only the sales shipped during that specific time frame when reporting.

### **Completing the Volume/Sales Section:**

**Company Name:** Indicate company name.

**Commodity Credit Corporation Sales:** Total the Commodity Credit Corporation (CCC) sales under the support purchase price program - this is reported in pounds sold and total dollars received.

- Please note that sales of NFDM should be reported at the price sold without regard to whether the price is lower than any existing support purchase price.

### **All Other Sales:**

**Pounds of NFDM:** Total the pounds of NFDM sold. Do not include:

- Sales or transfers to other plants in the same company or cooperative association (intra-company sales);
- Sales of organic, skim and whole milk powder, dry buttermilk powder, instant NFDM, and dry whey products;
- Re-sales of purchased NFDM.

**Total Dollars Received:** Total the dollars of sales including energy surcharges (arms-length transaction).

**Exclude:** Transportation, clearing charges and broker fees from total dollars received. If the processing plant delivers product in their own trucks and the plant cannot separate their delivery cost from their delivered price to achieve an F.O.B. plant price, then this sale shall not be reported.

**Credits:** Credits for sales are to be included in the monthly report only if the original sale was in the same week as the credit week. Other credits for prior week sales are not to be included.

**Total Sales:** Total the CCC sales information and All Other NFDM sales information.

### **Detailed Summary Sheet:**

Please include the following:

Invoice Date and Invoice Number  
Shipping Date  
Customer Name  
Plant Producing the NFDM  
Product Type  
Actual Pounds/Quantity  
Unit Price  
Broker Fees  
Energy Surcharges  
Total Dollar Amount  
Identify Fixed Price and Indexed Contract Sales

This Hearing Panel Report has been prepared and submitted by:

*Original Signed by:*

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David Ikari, Chief  
Dairy Marketing Branch

*Original Signed by:*

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Research Manager II  
Dairy Marketing Branch

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Senior Agricultural Economist  
Dairy Marketing Branch

*Original Signed by:*

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Michael Francesconi  
Supervising Auditor  
Dairy Marketing Branch

## Appendix A

### SUMMARY OF TESTIMONY AND POST HEARING BRIEFS

#### **NATIONAL MILK PRODUCERS FEDERATION (NMPF) – Jerry Kozak**

- California's Class 4a pricing formula should be modified to be properly aligned with federal order pricing.
- NMPF has worked to make California's milk pricing system compatible with the federal milk marketing order system, notably by:
  - Support for the Milk Regulatory Act
  - Recognition of state milk pricing programs within the federal order system.
- NMPF recommends that the California Weighted Average Price (CWAP) include domestic sales prices set up to 30 days before the sale and export sales prices set up to 90 days before the sale.
  - This would allow a price based on a substantial share of California export sales while providing a more current milk value to California producers.
  - This would bring greater order to milk marketing in both California and federal order markets.
  - NMPF will also recommend this for USDA's nonfat dry milk price survey, as a comment on the recent interim final rule on mandatory dairy price reporting.
- If CDFA is to adopt a USDA price series, NMPF recommends to use the same nonfat dry milk price series to price Class 4a that USDA uses to price Class IV milk: currently the National Agricultural Statistics Service (NASS) nonfat dry milk survey.
- The long-term viability of California and federal pricing systems depends upon their effective coordination.
- NMPF agrees with the Alliance of Western Milk Producers' alternative proposal that organic nonfat dry milk should be excluded from the CWAP survey.

#### **WESTERN UNITED DAIRYMEN (WUD) – Tiffany LaMendola**

- CWAP has historically tracked well with NASS pricing series. However, this historic relationship was disrupted starting in late 2006. Inclusion of long-term contracts in CWAP was singled out as the reason for the difference.
- WUD's members asked for a better understanding as to why NFDM prices reflected in California were lower. Industry meetings were held, but information offered was minimal so a formal hearing process seemed the best way to get the appropriate facts.
- Although the long-term contract which depressed NFDM prices in California was filled in June and prices are in better alignment, WUD proposed changes to CWAP procedures to avoid a recurrence.
  - Only contracted sales delivered within 90 days of contract execution should be included in the weekly and monthly CWAP prices.
  - Suggest separating out contracted sales on the reporting form as a possible mechanism to identify volume and prices associated with those sales.
- It is important to capture NFDM prices that are reflective of current market conditions while allowing some flexibility in the marketing of NFDM and price risk sharing.
- Because of lower CWAP in 2007, pool prices were lower for several months. Usual predictors or prices were muted against large volume of powder priced many months. Outcomes such as this are in conflict with the general intent of end-product pricing.
- The exclusion of contracts over 90 days does not mean that marketers cannot offer longer contracts; it just means that the risk will need to be hedged. Risk before 90 days will be borne by the producer; over 90 days by the manufacturer.
- Dairy America (which markets majority of powder in the U.S.) has a partnership with Fonterra, the world's leader in dairy products exports. This could enhance the ability to market U.S. powder in the world and reduce hurdles to international trade.
- U.S. Dairy Export Council (USDEC) provides a lot of information to help marketers capture and maintain international markets.
- Most contracts are volume driven. Producers generally have no control over forward contract specifications or time frames, but do assume the risk during occasions when lower price contracts are included with higher priced spot loads in monthly CWAP price. WUD wants both parties to assume a portion of the risk due to price movements, up or down.
- Marketers have the ability to use risk management tools. WUD recognize some initial resistance (and potential barriers) to trading NFDM futures at the CME exist, but this market could eventually experience the same liquidity and interest as other dairy contracts at the exchange.

- There is no way to predict when USDA will issue a final rule. California has the ability to make timely adjustments and is seen as a leader in dairy policy – USDA will look at CDFA for partial guidance in their decision in the final decision.
- NMPF will submit suggestions to USDA similar to WUD regarding long-term contracts (exception: 30-day limitation for domestic sales).
- If California stays with no limitations, and USDA adopts its interim ruling, a big divergence is likely to occur between California and federal order pricing. This type of situation would be a catalyst for disorderly marketing and arbitrage is likely to develop.
- Milk Producers Council Petition cannot support the NFDM as reported by dairy Market News because it is based on information collected via informal means, it is not audited; instead, they wish to maintain the price reporting in California under the oversight of CDFA and industry stakeholders.
- WUD does not oppose the exclusion of organic milk powders.
- The proposal of the Dairy Institute of California is similar to WUD in that it seeks to reflect current market conditions by allowing only a 30-day window for inclusion of fixed priced contracts.
- CDFA will be tasked with making the final decision regarding the specifications for NFDM reporting, therefore WUD offered the following suggestions:
  - Exclusion of high-heat NFDM - Dairy Market News is the only source that differentiates among the low/med/high NFDM prices, but CDFA does not. Therefore, WUD does not see justification for excluding high heat NFDM.
  - Container sizes - CDFA should continue to collect all container sizes since CWAP sales reports include all types of Extra Grade and Grade A NFDM regardless of container size.
  - Age of Product – no need to adopt the exclusion criterion of NFDM products older than 180 days as suggested by NASS.
  - Intra-company sales – unclear as to differences between USDA's and CDFA's procedures respecting product transfers within same organization as "sales". However, WUD objects to any deviation from CDFA's procedures.

#### **MILK PRODUCERS COUNCIL (MPC) – Geoffrey Vanden Heuvel and John Kaczor**

- According to MPC, the real issue is how CDFA will bring California's milk pricing formulas into compliance with the law.
- Cited Food and Agriculture Code §62062 excerpt on the criteria that CDFA should use in setting milk prices and the comparison point to which any price set must conform.
- California milk prices shall be in a reasonable and sound economic relationship with the national values so that California producers and processors are not at a competitive disadvantage relative to the rest of the country.
- Testimony and evidence from last year's hearing regarding 4a and 4b price formula allowances were cited. The dairy industry is competitive to the extent that fractions of a cent per pound of product are valuable and in their opinion is not the current trend with respect to differences in determining the value of NFDM in California.
- The product price for which the 4a and 4b formula pricing allowances were made were not an issue last year, but it is presently and it is costing California producers millions of dollars.
- The price problem with NFDM was first noticed in 2006 and resulted from the inclusion of sales by a major California manufacturer that set up long-term contracts that included the exporting of NFDM at below marked prices.
- The vast majority of NFDM in the U.S. is controlled by one entity with various plants throughout the country. Since California powder reporting rules allows for low, long-term contract prices when establishing 4a minimum prices, filling those contracts from California could be a protection.
- The NFDM price collected by CDFA for determining Class 4a formula is not keeping up with national value and the price difference between California and NASS has cost producers a staggering amount.
- MPC and other California producers have been petitioning CDFA for a change in order to address this crisis, and they are wondering why CDFA has waited so long to address issue.
- Mr. Kaczor presented data outlining the magnitude of this issue – reports and calculations comparing NASS and CDFA differences were used to evaluate and validate MPC's proposal.
- The report "NFDM Prices, Weighted Annual Averages, 2002 to 2007" shows a consistent and close relationship between CWAP and NASS series, with the latter being considered the most objective measure of the national average. CWAP followed this path until the first half of 2006.
- The relationship between the two provides a baseline for measuring the normal differences between the two, and also serves as the best measure of a "reasonable and sound economic relationship" for NFDM prices between California and the rest of the U.S.

- One concern is that NASS values can be “managed” by indexing prices for portions of the current sales to the prior week’s prices, which explains the difference between NASS prices and those reported by the USDA in the Dairy Market News.
- Calculations for the losses were determined by taking the differences between NASS prices and CWAP prices listed per the document “Various NFDMS/SMP Prices, Monthly and Annual Averages, 2002 to 2007” by CDFA.
- The purpose of getting these numbers into the record for this hearing is to show what can happen when an organization that controls about ninety percent of a closed market has no accountability for its actions.
- Table presented at hearing – “Impact on California Producers – Resulting From Difference Between the NASS Dry Milk Prices And The CWA Prices For The Period December 2006 Through July 2007” shows a loss of \$184,467,737.
- Mr. Kaczor was asked to address the question of why CWAP fell so far below the national average so fast. He concluded that millions of pounds of NFDMS sold under long-term contracts were being incorrectly reported to NASS and the extent to which this affected the week-to-week prices that were carried forward through the price indexing practice.
- NASS formally questioned the sales reports it had been receiving after a letter from an industry-minded organization was sent to the Inspector General in February. This inquiry resulted in corrections to four weekly sales reports.
- The conclusions of the study by MPC are as follows:
  - Assuming that member plants of the state’s major NFDMS sales agency produce 90% of the state’s production, during the December 2006 – June 2007 period, their percentage U.S. production averaged 49.0%.
  - It is believed that the major California dairy product sales agency is the only exporter of NFDMS produced within the state, that entity could have therefore exported 75.2% of U.S. total.
  - California plants who are members of the major sales agency could have exported 88.5% of the total NFDMS. This is what MPC refers to when they allege that disproportionate amounts of low-priced exports are being borne by California producers.
  - The decision to assign a disproportionate amount of its low-priced long-term contracted sales to its California plants makes good business sense for that sales agency because those prices are combined with its domestic sales, and they translate directly into its cost of milk for those sales.
- In March 2007, 66,595,600 pounds (lbs) of NFDMS were sold; USDA’s Foreign Agricultural Service (FAS) reported 47,816,003 lbs were exported, which NASS reported at \$1.2595/lb. The only combination of exported volume at the declared value for exports and domestic volume at NASS prices that will equal the California volume and value is 36,887,482 lbs exported and 29,708,118 domestic. The exported amount represents 77.1% of U.S. total pounds exported for the month.
- The attempt was made to apply the same calculation procedure to March of the previous year, but was unsuccessful because CWAP and NASS prices were both lower than the export prices.
- Another aspect to the issue of NFDMS prices sold for export is the discovery of prices. This means that prices f.o.b. ports in major trading countries are considered “very valid” by USDA; the low-end of those prices are consistently above those reported in the U.S. for export; and the specific prices for NFDMS exported under the long-term contracts per the NASS special report, validates the prices reported for exports of NFDMS.
- MPC arrived at 8 conclusions:
  - Immense profits are being made from selling NFDMS for export purposes but producers are not on the receiving end.
  - Spot market “mostly” prices appear to be better gauges of current prices.
  - Inter-state agencies have the ability to share costs and revenues on a nation-wide basis.
  - California has been used as dumping ground for clearing NFDMS.
  - The major California sales agency for NFDMS has incurred virtually no losses on its sales for export purposes.
  - The sales programs used by the major California sales agency are good business decisions for that entity.
  - Unless something is done in California to either control what is reported for NFDMS sales, or the basis for determining the cost of milk used to produce NFDMS is changed to an independent source, the producers will pay the price of selling at cut-rate prices.
  - The present basis for setting prices for Class 1, 2, 3 and 4a milk is not sensible or supportable under current market conditions.
- Mr. Vander Heuvel stated that the structure of the California system allows powder makers to transfer the entire risk of their marketing decisions to all of the state’s producers through the 4a formula and pooling system.

- It is believed that forward pricing has been included in the CDFA reports and it is not reasonable for dairymen to take the risk for forward priced sales by manufacturers.
- In the case of powder, the influence of forward priced sales is hard wired into the real time price.
- MPC believes it is illegal for the Secretary to establish milk-pricing formulas that exposes California producers and processors to a minimum price that is out of line with the national value of manufactured milk products.
- Using a California only plant price survey when there are only two organizations reporting and one makes up 90% of the volume in the survey is inherently flawed and not appropriate to use in the Class 4a formula.
- MPC proposes the use of the simple average of the NFDN – West mostly prices as published in the Dairy Market News (DMN), which is the same procedure currently being used in the state to establish the Dry Whey product value for usage in the Class 4b formula.
- The reason for this proposal is that it is independently determined by the USDA and reflects the majority of sales and offers to sell that occur weekly in the eleven western states and the average rarely differs from the Central Mostly report.
- Recommend CDFA adopt the DMN NFDN price to establish the powder product value in the 4a formula.
- Because the Class 1 formula also includes the usage of the current faulty California powder survey used in the 4a formula, it is suggested that a similar change be made to that formula as well.
- MPC is skeptical that a system of plant price surveys can be sufficiently repaired given that one organization controls 90% of the product volume.
- It is understood that price formulas in the federal orders are driven by product values established by plant surveys developed by the NASS and the Secretary is required to pay attention to those.
- If CDFA decides to continue with the plant survey price in the 4a formula, then the reporting process must change. MPC believes that the Dairy Institute's alternative proposal is the closest to lining up the California reporting value to the NASS procedures.

#### **DAIRY INSTITUTE OF CALIFORNIA (Institute) – William Schiek**

- The commodity price used in an end-product pricing formula is of paramount importance in establishing valid market-based prices for producer milk; and at stake at this hearing are proposed changes to the price NFDN used in establishing Class 4a, 1, 2, and 3.
- Dairy programs must be operated so that the public interest is served. § 61802 (e) states that it is the policy of the state to promote, foster, and encourage the intelligent production and orderly marketing of market milk and to eliminate economic waste, destructive trade practices, and improper accounting for market milk.
- The Secretary has been directed by the legislature to conform the pricing standards governing minimum producer prices for market milk to current economic conditions (§61805 (g)) and to consider any other relevant economic factors in setting milk prices that are not explicitly set forth in the Code (§ 62062).
- Historically, CWAP has tracked closely the price set by NASS and the Agricultural Marketing Service's (AMS) Dairy Market News Western NFDN price. However, in late 2006 and into 2007, CWAP and NASS prices began to diverge. There are structural differences in the methods used to determine the value of NFDN for the California Class 4a formula and for the federal Class IV formula. These differences continue to exist, and this could lead to a recurrence of price discrepancies in the future.
- NASS prices exclude forward fixed-priced contract sales more than 30 days old and are likely to be more representative of current market conditions than are CWAP prices. Institute believes that CWAP has performed well over the years and would like to see some changes to ensure that this series more fairly represents current market conditions.
- Institute proposes to alter the products to be included when calculating the price to be adopted administratively rather than in an amended stabilization and marketing plan.
- Institute proposes that the pricing specifications set forth in the recent interim final rule by USDA's Agricultural Marketing Service and currently being utilized by NASS in its NFDN prices survey, also be used in the weekly and monthly California NFDN sales reports.
- The USDA's specifications being used by NASS are as follows:
  - Sale: When and transaction is completed.
  - Price: f.o.b. processing plant/storage container center (prices and quantities for all sales).
  - Include: NFDN manufactured using low or medium heat process, CCC purchases under the Dairy Price Support and related programs, and CME sales by initial manufacturer.
  - Exclude: Sales do not exclude those through the Dairy Export Incentive Program (DEIP). For a detailed list of all proposed exclusions, refer to Institute's testimony for August 28, 2007 (hearing brief #48.)

- Adoption of these modifications will result in three main benefits:
  - More transparent milk price determination
  - More predictable basis between federal and California raw product costs for Class 4a, 3, 2, and 1.
  - Additional incentives for NFDM suppliers to utilize the futures market, which would increase market liquidity for the benefit of the industry.
- Proposes modification of CWAP to achieve milk price transparency - not allowing long-term, low-price contracts to set at one point in time to artificially lower the product price.
- Congruency between federal and California pricing will provide for fewer disruptive marketing conditions.
- Greater use of futures markets – to date NFDM futures market has been slow to develop. However, recent history with cash-settled butter and dry whey futures contracts has shown that these markets can become liquid reasonably quickly when both product buyers and sellers have incentives to use these contracts.
- Institute's position on other proposals presented at this hearing:
  - Does not support Western United's proposal for a 90-day limit on the contracted sales included in the CWAP.
  - Recommends that the proposal by Milk Producers Council to use information collected by Dairy Market News should be rejected because the information would be incomplete and it might create a moral hazard issue.
  - Does not support the proposal by Alliance of Western Milk Producers regarding the exclusion of organic NFDM because it would cause a price inconsistency between NASS and California.

**ALLIANCE OF WESTERN MILK PRODUCERS (Alliance) – William C. Van Dam**

- This is a changing world - there is an increasing demand for dairy proteins, a marked decrease in dairy production from the European Union, and a continuing drought in Australia, which projects decreases of milk production in the coming year.
- Those plus other factors have created an opportunity for California to dairy producers to market NFDM world wide, especially with export sales to the West.
- Demand for NFDM is high, prices are attractive, and Alliance's conclusion is that this trend will continue because few places in the world can respond to such demand.
- Great care must be taken to ensure that regulations are flexible enough to allow California NFDM processors to engage in business transactions that will enhance California's position as a reliable major provider of NFDM and other dairy products.
- Alliance's position on CWAP is that it is still a better option for California than any of the new proposals at this hearing because it uses the actual values for standard NFDM as the basis for determining the price paid by plants for their milk.
- It is Alliance's opinion that the proposals at this hearing would create a regulatory environment that moves away from a system that has worked well for decades based on the very unusual price and market circumstances that occurred during a short period in 2007.
- Alliance does not believe that NASS is a better gauge because it is a relatively new series that never went through the formal rulemaking process like CWAP.
- Recommendation is that organic NFDM be excluded as reportable. This is because organic products sell for much more than commodity NFDM and this may force the other processors to pay more for their milk than can be recovered from the market place.
- Alliance is opposed to proposals as listed below:
  - WUD – Alliance believes that all sales of the properly defined commodity products should be included whether sold on long-term contracts or as spot sales.
  - MPC – Alliance sees the Dairy Market News report data as loosely gathered and informal.
  - Institute – Alliance does not believe that using NASS prices or to change CWAP to follow the same rules would be detrimental to the industry's ability to market California's NFDM internationally.
- Two negative consequences to creating new regulations:
  - Potential export sales will not proliferate forcing more product into the domestic market.
  - Resulting overabundance of domestic supply will negatively impact prices.
- Alliance believes that exclusion of organic NFDM from CWAP calculations will yield a more accurate price and that long-term contracts should continue to be included as part of CWAP reporting.
- A rush by the California dairy industry to make far-reaching changes in response to the recent unusual circumstances could prove detrimental to NFDM producers and processors.

### **CALIFORNIA DAIRIES, INC. – Joe Heffington**

- CWAP has served the California dairy industry for many years.
- The assumption that all long-term fixed price contracts end up at a lower price than the prevailing market price is false.
- The future for California's growing milk supply lie to the West with export markets.
- Long-term contracts are more the norm in export markets.
- California's largest milk powder market, Mexico, is mostly contracted through Liconsa, which bidding process usually put the fixed contracts at a minimum of seven months in duration.
- Excluding sales from CWAP would place tremendous risk on manufacturers, which might be more reluctant to export. This would leave more volume on the domestic market, which lower domestic prices.
- Current reporting rules are flexible enough to allow NFDM processors to engage in exporting transactions.
- CWAP's was reviewed at industry meetings in the 1990's, notably on accuracy and timeliness issues. There is no other system like that in the U.S.
- NASS is behind on efforts relating to reporting rules for NFDM. Alignment with NASS is not necessarily in California producers' long-term best interest.
- Export markets are very encouraging and have great potential for the future. Regulations that support development of these markets is what is needed.

### **LAND O'LAKES, INC. – Tom Wegner**

- Exports are important to the future growth of the NFDM market.
- Terms of sales differ when entering an export contract relative to a domestic contract.
- CDFA should stay in close contact with USDA regarding the Proposed Interim Final Rules that relates to the collection of NFDM values.
- California plants produce annually around 50% of the NFDM in the U.S.
- Exports are a key component in NFDM market future – 42% of U.S. NFDM got exported in 2006. If exports had not been that robust, that milk could have ended up in cheese and whey, further depressing those markets.
- LOL's participation in Dairy America allows its producers to benefit from collectively marketing NFDM.
- International sales have become a critical component of the market – Dairy America YTD exports of NFDM represent 33% of sales.
- Exports play an important role in the market strength – rising NFDM prices driven by international demand have directly benefited California's milk producers.
- Export sales are usually made from commitments of future production. Shortest contracts typically cover small volumes (i.e. 2 million lbs) and take 30-60 days to complete. Longest cover bigger volumes (i.e. up to 40 million lbs) and can take from 180-360 days to complete.
- Vast majority of NFDM export sales in recent years go through time consuming documentation process and contain fixed prices that extend well beyond 30 days.
- The lack of 4a futures market limits NFDM's customers' ability to hedge sales or purchase contracts for future delivery.
- LOL would prefer if USDA made no distinction between spot, domestic and export sales. LOL will therefore urge USDA to expand their price survey to include fixed price sales with terms up to 90 days.
- Limiting export sales to 90 days or less could inhibit ability of suppliers to export important quantities of powder.
- Including exports beyond 90 days could benefit dairy producers in a down cycle in powder markets.
- Organic NFDM should be excluded from the CWAP.
- DMN should not be used considering those prices have no volumes accompanying them and they are not audited.
- Long-term interests of producers would be served best with the use of the current CWAP.
- If USDA keeps a 30-day limit, LOL would still continue to support including sales within 90 days of contract execution.

### **NESTLE USA AND DREYER'S GRAND ICE CREAM HOLDINGS, INC. – Patricia Stroup**

- Supports DI's alternative proposal to change the specifications for products to be included in the weekly and monthly NFDM sales reports.
- A short period like 30 days allows for supply and demand signals to be transmitted efficiently and rapidly.
- A 30-day time period is consistent with the important goal of price transparency because including long-term contracts with delivery prices reflecting prices set in the past would reduce price transparency.
- A 30-day period allows consistency with CDFA price formulas.
- Section 61802 of the California Food and Agriculture Code says that pricing standards for market milk must conform to "current economic conditions".
- A 30-day period is consistent with USDA's interim final rule. This is desirable to bring CWAP into a "reasonable and sound relationship" with federal prices.
- If the Department decides to use a period longer than 30 days, it should compensate for the lack of transparency by providing information on product volumes delivered under prices set at various intervals.
- Oppose the use of DMN. The methodology used to collect information is based on personal discussions between manufacturers and reporters and this is not a credible methodology for setting mandatory regulated prices.

### **CALIFORNIA DAIRY CAMPAIGN – Scott Magnuson**

- Because the CWAP used in 4a and CRP does not reflect the national value of NFDM used in surrounding federal orders, California's class prices will not be able to maintain a "reasonable and sound relationship with the national value of manufactured milk products".
- CDC requests the use of DMN price series instead of CWAP.
- Long-term contract work both ways by keeping prices higher longer on a down market (i.e. CME cash price moved higher it took a year for CWAP to adjust and when it decreased CWAP dropped immediately).

## **POST HEARING BRIEFS**

### **CALIFORNIA DAIRIES, INC. – Joe Heffington**

- Dairy America's contracts extend well beyond the 30-day limit proposed by DI and even beyond the 90 days limit proposed by WUD and LOL.
- Contracts are based on volume, so depending on the availability of the product the expected duration of the contract may change.
- 78% of the volume exported under contracts to which Dairy America was a party from January 2006 to July 2007 extended well beyond the 90-day time frame.
- Relationships with export customers take time to develop.
- Long-term contracts are the norm in export markets and companies involved must operate under those rules.
- In response to a witness that quoted J. Heffington: that quote was taken out of context and applied to butter. Sales of nonfat dry milk and butter operate under different business models. Butter is almost exclusively sold domestically, while around one fourth of NFDM is sold internationally.
- Sales of organic NFDM should not be reported to NASS.

### **MILK PRODUCERS COUNCIL – John Kaczor**

- Virtually every plant reporting to NASS in the 11 western states report weekly prices to DMN. Major buyers are also contacted.
- AMS believes their coverage is sufficiently inclusive of all buyers and sellers in the western region to be a fair representation of market conditions.
- MPC affirms that DMN mostly prices for the western region serves as a valid basis for current NFDM prices and satisfies the specific mandate to the Secretary to use a source that results in milk prices that are reasonably representative of current national values.
- The reason why MPC is interested in a true audit of California's major sales agency is to find out how they share costs, revenues, and profits associated with NFDM.
- A financial audit should be conducted to answer questions about the meaning of references to "profit sharing" and "sharing of losses" made by member of Dairy America. If revenues were found to be to the detriment of California producers, a case could be made that improper accounting procedures are occurring.
- Dairy America's cost for the milk used to produce the dairy products to fulfill contracted requirements could be higher than the price received for the finished products (they can be dealt in California for a plant in a federal order that faces different prices). How do they resolve these losses?
- The lack of accountability mentioned in MPC's testimony referred to Dairy America. A true financial audit should be conducted.

- MPC encourages Dairy America to continue their efforts to contract for nonfat dry milk exports. However, the statutory standards for determining milk costs for those exports are legal requirements that must be complied with.
- Potential risks and benefits exist with fixed price long-term contracts. When California plant chose to offer those prices, they must be placed on the same footing as plans in other states, as the statute requires.
- The Secretary can bring the present formula used to determine milk prices for Class 4a in compliance with Code section 62062 by three means (in order of preference): use DMN, use NASS, or use Dairy Institute's proposal.