

October 15, 2007

Mr. David Ikari, Branch Chief
Dairy Marketing
California Department of Food and Agriculture
560 J Street, Suite 150
Sacramento, CA 95814

Re: October 10-11 Class 4A-4B Hearing – Post Hearing Brief

Ms. Hearing Officer and Members of the Panel:

I am submitting a post-hearing brief on behalf of Kraft Foods following the October 10-11, 2007 CDFA hearing on adjustments to the 4A and 4B milk price formulas and the removal of the whey component from the 4B formula.

Question regarding plant expansions

Mr. Gossard asked about the plant expansions noted in the April 2006 Dairy Foods magazine article and which ones were in CA. Only 3 of the 41 projects listed are in the state of California: Dreyer’s ice cream plant in Bakersfield, Straus Family Creamery’s organic plant in Petaluma, and CDI’s butter-powder plant in Visalia, with this being the only one that will add any meaningful manufacturing capacity to the state. The full article is attached as Appendix 1.

Question regarding pricing of wet, skim whey solids in WCMA survey

Mr. Shippelhouse asked about the WCMA survey and the details on the pricing for wet, skim whey solids in June of this year. The direct quote is as follows: “WCMA 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.”

Question regarding 2007 milk supply situation vs prior years

I summarized USDA Dairy Market News reports on the CA milk supply situation this year and noted the number of times plants had difficulty handling milk, had to move milk out of state, or dumped on the farm. Mr. Gossard asked for a similar analysis for prior years. The table below shows the number of weeks and percentage of times each occurrence was mentioned by USDA. Each of these occurrences are significantly higher in 2007 versus the last two years. Therefore it is clear there is a lack of manufacturing capacity in the state of California.

YEAR	Problems handling milk in CA	Milk/components moving to other states	Milk dumped on farm *
2005	3 of 41 weeks (7%)	0 of 41 weeks (0%)	0 of 41 weeks (0%)
2006	10 of 41 weeks (24%)	3 of 41 weeks (7%)	1 of 41 weeks (2%)
2007	25 of 41 weeks (61%)	21 of 41 weeks (51%)	4 of 41 weeks (10%)

* Given that milk marketers are often reluctant to report milk not being marketed due to environmental concerns, it is likely that these numbers are extremely conservative estimates about the times when milk was being dumped or left at the farm.

In addition to the numbers provided above, I've also reviewed the weekly Dairy Market News for the past 3 years. Below is a sample of the comments from prior years focusing on milk handling during the spring flush period, the summer holidays, and the most recent week comparison.

Spring Flush

2005

March 25 - Processing plants in the state have capacity for additional milk and there are some cheese plants wanting extra milk for current cheese needs.

April 8 - The milk flow in the Central Valley is very strong with some processors seeing 4% to nearly double digit intake growth from a year ago. The additional milk is being processed within normal channels.

May 13 - Milk plants are running well and the milk is being processed orderly.

2006

March 24 - The upwards trend in milk output continues to build and processors are concerned about handling the peak milk supplies this year. Plant capacities are being taxed and down days are being discouraged.

April 7 - Processors are seeing lots of milk and several would not mind if the rains would take some of the milk increases. There are concerns over handling the milk supplies over the upcoming Easter weekend as schools recess and smaller processing plants take down days.

May 12 - Overall, there remains a surplus of milk in the state. Milk and components are moving to available processing plants.

2007

March 23 - Many manufacturing plants are running at capacity levels and milk has not peaked. The spring flush is happening earlier than normal and some plant operators hope that means the milk will drop off earlier also. The surplus milk seems to be handled more efficiently this week as some time has allowed for better arrangements to have been made. Some milk is leaving the state for other destinations in the region.

April 6 - The strains on handling milk efficiently in the system that had improved over the last two weeks are being stressed again this holiday week. More surplus milk is available and trucks are very hard to find to haul any form of liquid milk product to different destinations.

May 11 - Manufacturing plants now have some capacity to handle milk supplies more efficiently.

Memorial Day

June 3, 2005 - Processors in the state were able to handle the milk supplies in a relatively orderly fashion over the holiday weekend and were returning to normal schedules by midweek.

June 2, 2006 - CALIFORNIA milk processors are reporting that milk was handled well over the extended holiday weekend. There were only minor problems reported and contacts were pleased with the results.

June 1, 2007 - Processors reported that milk handling over the holiday weekend was generally uneventful. Plants were running on schedule and able to handle the current milk supply.

Fourth of July

July 8, 2005 - Generally, milk was handled decently over the holiday weekend. There were some plant problems and other plants that were full.

July 7, 2006 – The recent downturn in milk helped processors make it through the extended holiday with few problems. Milk handling went well with few problems reported.

July 6, 2007 - Plants had few problems handling milk over the mid week holiday. The biggest issue was that smaller plants closed on and around the holiday and that milk moved into other plants for balancing.

Labor Day

September 9, 2005 - Processors in the state had few problems handling any surplus milk over the holiday weekend.

September 8, 2006 - Processing plants in the state are running as expected. No issues were reported handling milk over the extended holiday weekend.

September 7, 2007 – Hot and humid weather conditions have been widespread over the milk producing areas of CALIFORNIA during the past week and milk output is lower. Processing plants were seeing intakes anywhere from 6% to 14% lower than a week ago. The decline made milk handling uneventful over the Labor Day weekend.

Early/mid-October

October 14, 2005 - Processing plants are running on expected schedules and not taxed at the present time.

October 6, 2006 - Some churning and drying facilities are operating under reduced schedules, due to less milk being funneled to those uses. Cheese plants, responding to seasonal product demands, are getting a good share of the milk output, adding to the volumes bypassing churns and dryers.

October 12, 2007 - Current milk supplies are stressing processing capacity and the ability to balance. There are reports of milk not being picked up at the farm because of the lack of space.

Additional USDA Dairy Market News reports

In my testimony, I attached an appendix with the USDA Dairy Market News reports this year on milk and cream supplies in CA and surrounding states. Following the hearing, the latest week's report became available and is as follows. While an excerpt is noted above, the following is the full text.

CALIFORNIA milk output is strong across the major milk production areas. Current milk supplies are stressing processing capacity and the ability to balance. There are reports of milk not being picked up at the farm because of the lack of space. There were several plants that had issues this week, which compounded handling concerns. There are reports that several processors in the state will implement base plans to limit milk that they will process from their producers. Fluid milk orders are steady and along projected levels. Milk is being shipped to nearby states to find processing homes.

I found several points quite interesting. First, they noted reports of milk not being picked up at the farm because of lack of space. This means milk was dumped on the farm and is one of only a couple times this year the USDA mentioned this situation. With NFDM over \$2.00/lb, cheese over \$1.80/lb and milk prices near record highs, the market is begging, screaming for more dairy products. When milk is dumped on the farm, the CA dairy industry loses an opportunity to fill this new and growing demand in the domestic and world markets. The second and more interesting point is the comment about several processors implementing base plans to limit milk from producers. This is the first time I recall this type of comment in the Dairy Market News and if implemented, could have negative long-term implications for the CA dairy industry. It seems the fundamental question is whether or not CA dairy farmers want to grow and be the supplier for increasing dairy product demand both in the US and globally. To do so, dairy farmers need to realize the need to continue to develop and foster dairy manufacturing capacity in the state to handle their growing milk supplies.

More on Milk Disposition

There were a number of testimonies regarding the disposition of milk in CA this year. This included detailed comments from milk handlers on the difficulty handling milk to moving milk out of state for a processing home to even milk being dumped on the farm. There were also several comments about the difficulty in finding trucks to handle the milk this year. Given the Panel's questions to a number of companies testifying, I found it strange the same questions were not asked to the witnesses from CDI. As the largest cooperative in the state, their comments on this subject would have been quite useful for the hearing record.

My testimony noted significant amounts of milk, both raw and UF, leaving California. This milk is going to processing plants in the Northwest, Southwest, and even the Midwest. When asked, Mr. Jeter from Hilmar provided details on milk into UDA (AZ) and Hilmar's new plant in TX. Again, I was surprised I was not asked to provide details following my testimony, but in any case, hesitate to do so given the proprietary nature of milk purchasing. If the Panel would like this information, and could provide a way for me to confidentially disclose it, I would be able to give more details such as number of loads and plant locations. There were also some questions and discussion on this distressed milk that moved out of state. Again, I was not asked any questions on this topic, but would like to provide the following information. For the milk moving into ID from CA, it incurs over \$3.00/cwt in trucking costs. The distance from Tipton, CA to Jerome County, ID is over 825 miles. At \$2.00 per loaded mile, this is \$3.30/cwt for a 50,000 lb truck load. Additionally, this distressed milk is sold for \$2.00/cwt under class normally. So, the net price is more than \$5.00/cwt less than class price delivered or a loss of \$2500 per load. These losses are realized by the cooperatives and are passed on to farmers in the form of lower milk checks. So, as I stated in my testimony, the losses from handling the milk surplus in CA are being borne by farmers now. Therefore, I raise another fundamental question – 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? The growth of California's dairy industry has been due to

healthy, dynamic producer and processor segments. It would seem the state would want this trend to continue by removing the whey factor from the 4B formula thereby creating the incentive for companies to invest in much needed manufacturing capacity.

Comment on whey operation ‘profitability’

In testimony and comments from the Alliance, Bill Van Dam talked about the profitability of whey operations this year. If I understood it correctly, the record high dry whey prices resulted in whey operations making money, lots of money, this year. There were similar comments from several other producer groups. While they weren’t questioned on these assertions, I would like them to explain how they arrived at their figures. Per CDFA’s manufacturing cost survey, only one of the dry whey plants can cover their costs with the current manufacturing allowance. And while it’s true whey prices reached record high levels this year, every penny above the make allowance was passed through to dairy farmers in their milk checks. So, how did these whey operations have such a profitable year? They didn’t and several cheese companies with whey operations provided testimony to prove it.

Summary

The addition of the whey factor to milk price formulas in 2003 has caused financial hardship for cheese plants. The Department broke from long-standing position in adding it to the formula in 2003 during a time of low milk prices. At hearings in 2005 and 2006, proposals were made to remove the whey factor. And each time, the hearing Panel agreed. The producer groups finally realize the problem the whey factor is causing to cheese makers, but still not the depth of it. Their proposals do not go far enough to solve the problem. The best solution is to remove the whey factor from the 4B formula and also implement the alternate proposal from the Dairy Institute.

Thank you for the opportunity to provide a post-hearing brief.

Respectfully submitted,

Michael McCully
Associate Director, Dairy Procurement
Kraft Foods

Appendix 1

From April 2006 Dairy Foods magazine

New Plant Construction: Big Cheese Projects Heating Up

April 1, 2006

The latest in a long line of the world's largest cheese plants is up and running in Clovis, N.M., Leprino Foods is making major upgrades at several of its plants, and Hilmar Cheese is about to break ground at a greenfield site in the Texas panhandle. Cheese is not the only game in town when it comes to construction projects this year, but it seems to be the driver of the most substantial projects.

In upstate New York, Stueben Foods has begun a major expansion that will allow it to increase production of Horizon Organic milk. In New Hampshire Stonyfield Farms is doubling the capacity of its production facility to keep up with its double-digit annual growth.

Dairy Foods has identified 41 North American projects that are underway, in the planning stages, or have been recently completed. Certainly there are some out there that we do not know of, but this is a good snapshot of the current construction activities in dairy.

Mega cheese

Project partners Dairy Farmers of America, Glanbia Foods and Select Milk announced the Southwest Cheese project, in 2003. While the scope of the project has been known for some time, a Dairy Tech World Wide Food Expo presentation last year by Tim High, president of Carlisle Process Systems (CPS), really put it into perspective.

Southwest Cheese will be among the largest cheesemaking facilities in the world, producing more than 250 million lbs of cheese and 16.5 million lbs of whey a year. The 280,000 sq foot plant will employ 225 workers and will produce \$340 million in annual sales. The total cost when completed will exceed \$200 million.

The footprint site is 54 acres, but it sits within 2,000 acres that is controlled by the partners. And it includes a massive wastewater lagoon. CPS was hired as the main process engineer and worked with other companies including Tetra Pak, Millerbernd Design & Fabrication, Alfa Laval, Emerson, Rockwell and Fristam to design and build the systems at the plant.

CPS billed \$70 million on the job plus \$26 million for third party equipment. High said one of the biggest challenges to the project was managing the massive paper trail that was generated, and that was done through a dedicated website.

Not too far from Clovis, Hilmar Cheese is ready to begin construction near the Texas panhandle town of Dalhart. It's been little more than a decade since cheese began coming out of the the plant in Hilmar, Calif., but after wrangling with state environmental officials there for the past few years, the company has decided that future growth of its business will be in Texas.

Lone Star state governor Rick Perry joined the company late last year in announcing plans for the \$190 million plant which is expected to produce a half-million lbs of cheese daily once it's fully operational. Dalhart would begin first phase production in the fall of 2007.

Although its facilities are not nearly the scale of Hilmar and Southwest, Tillamook cheese has also stayed in the expansion mode the last few years. When Tillamook established the Columbia River Processing facility in Boardman, Ore., in 2001, it was designed to mirror the cooperative's headquarters plant in Tillamook. Now Tillamook is close to finishing an expansion at Boardman that will in effect give the company three times the production capacity it had before 2001. The co-op broke ground in early 2005 on the \$50 million project and it is hoped that it will be completed by late 2006. Once operating, Tillamook's cheese production per year is expected to grow to 190 million lbs.

Organic demand

Steuben Foods is planning an \$18 million expansion at its Elma, N.Y., plant to increase capacity for organic milk and soy products. An organic milk processing facility is also being added through a joint development with Horizon Organic. Previously, Steuben had no raw milk processing capability at the plant which also manufactures aseptic pudding and other desserts.

Last fall, Stonyfield Farm broke ground on a project that will roughly double the size of its Londonderry, N.H., plant and increase annual capacity from 66,000 tons to 136,000 tons.

The expansion is slated for a late 2007 completion and will feature green construction practices and material. It will encompass new production space for upgraded systems and an additional 4-oz cup line, plus warehouse, receiving bay, and office expansions.

Last year the nation's largest organic yogurt maker installed a 50 kilowatt (kW) solar energy system as a means of fighting global warming and demonstrating the company's commitment to supporting renewable energy projects.

The 5,000 sq ft photovoltaic array will generate about 50,000 watts of energy on full sun days—that's comparable to the amount of electricity 10 homes might use on an annual basis.

In addition to energy, the solar array also generates renewable energy credits, or "green tags," which represent the environmental benefits of energy generated by this non-fossil fuel source. Stonyfield Farm has donated the rights to all of the green tags generated by the project over its entire operating lifetime, about 25 years, to Clean Air - Cool Planet, a science-based non-profit with offices in Portsmouth, N.H., whose goal is to promote effective solutions to the threat of global warming.

Meanwhile Straus Family Creamery, Petaluma, Calif., is about to trade up to a 50,000 sq ft modern facility. Straus is a family farm-based company that sells a full line of organic dairy products made from the milk of their own cows and those of nearby organic farms in Marin County, Calif.

More cheese

Other companies investing in new plants or expansions include more cheesemakers. Leprino Foods, the leading pizza cheese manufacturer in North America will upgrade and expand six of its plants while adding a brand new facility in Michigan. Cabot Creameries, the cheesemaking division of Agri-Mark cooperative recently completed two plant expansions in Vermont.

As for milk plants, Dean Foods' Meadow Gold Dairies has completed its green field milk plant in Las Vegas, and there was some discussion early this year about the possibility that Dairy Farmers of America and a group of partners would be seeking a site in Kansas for a new milk plant.