MPC | MILK PRODUCERS COUNCIL

"Serving the Dairy Industry for Over 50 Years"

September 4, 2007

Michael Cleary, Hearing Officer
California Department of Food and Agriculture
1220 N Street, Room 409
Sacramento, CA 95814

RE: Post Hearing Brief

Dear Mr. Cleary,

Milk Producers Council appreciates this opportunity to amplify and explain certain aspects of the documents and oral testimony that we presented in the hearing held on August 28, 2007. This post hearing brief addresses three matters pertaining to our appearance in the hearing:

- A question to MPC regarding how the "mostly" prices are determined by USDA;
- Questions by MPC regarding the Department's auditing procedures;
- Appropriate comments pertaining to other proposals, which either support or oppose our position.

1. We contacted USDA's Agricultural Marketing Service, the branch responsible for developing and reporting weekly information on general market conditions, price levels, and related factors. With respect to the Nonfat Dry Milk - West "mostly" price range, we have been informed that virtually every plant in the eleven western states that report weekly prices to NASS (those manufacturing more than one million pounds of product per year) are contacted each week. In addition, major buyers, defined as those who purchase truck-lot quantities from those plants, are also contacted. Prices that are reported by USDA in the weekly editions of Dairy Market News are f.o.b. manufacturing plant. Buyers include end-users and brokers. AMS reports excellent participation from all who are contacted, and believes the coverage by their reporters is sufficiently inclusive of all buyers and sellers in the western region to be a fair representation of current market prices and conditions. AMS instructs its reporters to assure confidentiality, to be consistent and unbiased, and to question responses that cannot be confirmed or which appear to be unrepresentative of the market. Based upon that information, we are satisfied that the DMN weekly reports of the "mostly" prices for the western region serve as <u>a valid basis for current nonfat dry milk prices</u> and <u>satisfies the specific mandate to the director to use a source that results in milk prices that are reasonably representative of current national values</u>. Based upon the history of this price series' general relationship with the NASS national prices (meaning that it reflects current prices sooner) and with DMN's Nonfat Dry Milk - Central/East "mostly" series (meaning that they rarely differ by more than the cost of transporting

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product between the regions), we reaffirm our proposal for its use as the basis for establishing minimum prices for milk used to produce products included in California's 4a classification.

2. We thank the Department's prompt response to our inquiry into the procedures used to verify that the weekly and monthly reports of sales volumes and prices of nonfat dry milk are correct, and that no prohibited sales are included. We did not question their validity, and are pleased that our faith in the accuracy of the numbers is correct. The point of our inquiry was to verify that the Department does not conduct what could be considered a true audit. The response concluded with "The Department does not review the general ledger, plant inventory, or other financial records of the plants that produce powder." The reason we are interested in a true financial audit of California's major sales agency (hereafter, Dairy America, since a letter has surfaced which identifies its position) is to ascertain how they share costs, revenues, and profits associated with the nonfat dry milk sales reported on behalf of its California member plants.

In this case, a financial audit would include a review of financial statements for representative periods, analysis of transfers or sales of product between California and non-California plants, reconciliation of receipts and usages, changes in inventory valuations, and all dispersals, receipts, or allocations of money, rebates, credits, or allowances involving its members or its customers for the periods covered by the audit. It is critical for California producers to know that the disproportionate amount of long-term export sales that has been reported for California plants by Dairy America has not compromised their position as equal participants in California's milk pool. On the other hand, if it is found that revenues and costs associated with California's fixed priced long-term contracts is found to benefit producers in other states (including members of Dairy America's California members) to the detriment of revenue or prices for California producers, or is found to benefit Dairy America's California members but not California producers who are not members of Dairy America, a case could be made that improper accounting procedures are being practiced and, pursuant to section 61802 of the Code, must be stopped. The audit, which we believe Dairy America should welcome in order for it to then focus on business issues, would answer questions about the meaning of references to "profit sharing" and "sharing of losses" made from time to time by members of Dairy America.

Following is an example of why questions have arisen regarding possible post-sale adjustments within the Dairy America organization. It seems incomprehensible that a Dairy America member plant in Arizona or New Mexico, for example, would accept full responsibility for sales and costs relative to a long-term commitment to sell nonfat dry milk that was negotiated by Dairy America executives in California. The reason for this disbelief is that Dairy America member plants in federal order areas are not permitted to report sales under long-term contracts whose prices are fixed more than thirty days prior to the time the sale is made. That means their cost for milk used to produce those products, which is determined by NASS's summary of current sales, will not be related to the prices negotiated by Dairy America headquarters. Their cost for the milk used to produce the products in those areas to fulfill the contracted requirements would sometimes actually be higher than the price received for the finished products. The NASS special survey of nonfat dry milk sales published in June demonstrated that fact: in February, the basis for class IV skim milk costs was about \$.21 per pound higher than the average prices being charged for nonfat dry milk sold under long-term fixed priced contracts. In March the difference was about \$.25 per pound. In April the difference was about \$.40 per pound. The question is how were those loses resolved within the Dairy America organization?

The lack of accountability we mentioned in our testimony refers to activities of Dairy America. No one will dispute the reason for the disproportionate amount of long-term, fixed price, export

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contracts being awarded to California plants; it is in the hearing record. The decision to maximize those sales through California plants is simply a good business decision by Dairy America, for Dairy America, which we acknowledged in our testimony. It is their dominant share of the nonfat dry milk market in California that should make them more accountable and transparent as to their activities, rather than the opposite. The lack of accountability issue can be corrected by CDFA, by conducting a true financial audit. The authority for the director to proceed with an audit is prescribed in Code section 61894, which authorizes inspection and copying of books, papers, records, or documents in any place within the state in the enforcement of the Stabilization and Marketing Plans.

3. After hearing the arguments offered by the Dairy America group (California Dairies, Inc., Land-O-Lakes, and the Alliance of Western Milk Producers) in opposition to any change in the method used to determine the correct level for the state's class 4a minimum prices, one could get the impression that they do not believe that section 62062 and related sections in the Food and Agricultural Code have any meaning at all. At no time in their testimony did they even mention the existence of a statutory standard. And we do not recall any questions from the hearing panel regarding whether their proposals for no change or for little change would comply with the statute.

The thrust of the testimony by the Dairy America group was that any change from the existing reporting procedures would lead to sharply reduced exports of a product that is in great demand throughout the world. We, and others who argue that California cannot continue to be the dumping ground for low-priced exports that cause California producers to lose millions of dollars, relative to producers in adjacent states, encourage Dairy America to continue their efforts to contract for nonfat dry milk exports. <u>But the statutory standards for determining milk costs for those exports are legal requirements that must be complied with</u>. There are potential risks, as well as benefits and rewards, for offering fixed prices six, nine, or even twelve months into the future. When California plants choose to offer those prices they must be placed on the same footing as plants in other states, <u>as the statutes require</u>, regarding those risks, benefits, and rewards. Regarding potential risks, other witnesses pointed out that there are means available now to offset a large part of those risks, and as the global exchange for futures and options contracts continues to develop, their liquidity and therefore their function will serve to protect both seller and buyer.

Even the argument that international buyers require fixed priced long-term contracts was dismissed by the measured comments of Mr. McKnight, Vice President of Export Ingredients, Marketing and Industry Affairs, USDEC. His reply to that question was that long-term contracts are <u>preferred</u> by large buyers, as are fixed price contracts. Even more to the point was the testimony presented on behalf of Nestle USA, the largest purchaser of nonfat dry milk in the world. Ms. Stroup made it very clear that Nestle believes that only short periods of time (up to thirty days) should be used to measure changes in supply and demand, and therefore value, for particular products. "Inclusion of long-term contracts where delivery prices reflect supply and demand conditions during past periods would markedly reduce price transparency." Ms. Stroup stated that price fluctuations can be handled, but if the time period used to report prices is too long or is unknown, the prices themselves cannot be relied upon.

Except for the Dairy America group, all other witnesses supported a change of one kind or another to the procedures used to determine the appropriate market basis for arriving at minimum milk prices for class 4a usages. The supporting arguments included, first and foremost, that <u>the present procedure</u> which includes use of non-current sales prices <u>does not satisfy the statutory standards</u>, and could result in a recurrence of the losses California producers have recently incurred. Other points that support the need for changes included examples of the losses California producers have incurred because of the use of non-current prices, the likelihood of more losses in the future, market disruption, and misleading or ineffective signals of current product values.

The discussion by Dairy Institute of California of the kinds of initial disruptive effects on the marketplace for buyers and sellers from use of non-current price bases, and how that disruption can spread to the point where the majority of buyers and sellers throughout the U.S. are affected, was especially compelling. Also compelling was support for complete harmony between the basis used for setting prices in federal order areas and for California, expressed by the National Milk Producers Federation. However, proposals to anticipate a final decision by the U.S. Department of Agriculture to establish what would amount to an "export class for milk" should be disregarded for the simple reason that USDA and U.S. trade negotiators have noted that such action would violate existing binding agreements that have been reached in World Trade Organization negotiations. In other words, CDFA should not wait for something that will not happen.

In summation, the Secretary can bring the present formula used to determine minimum milk prices for the 4a classification into compliance with Code section 62062 by one of three means: he can adopt our proposal to use the simple average of the Dairy Market News - West "mostly" price range; he can use the NASS price series which is understood to reflect current national values; or he can use the proposal submitted by Dairy Institute of California, which would continue to use an amended California plant average price which would include reports of current sales only. We concluded our testimony on the 28th by noting our order of preference: if not the Dairy Market News - West "mostly" series, then the NASS national average price series, then Dairy Institute's proposal.

Sincerely,

Geoffrey Vanden Heuvel
Vice-President, Milk Producers Council

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